International Financial Reporting Standard IFRS 16

Leases

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BASIS FOR CONCLUSIONS

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Basis for Conclusions
International Financial Reporting Standard®

IFRS 16 Leases

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Basis for Conclusions on

IFRS 16 *Leases*

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Basis for Conclusions on IFRS 16 *Leases*

This Basis for Conclusions accompanies, but is not part of, IFRS 16.

Introduction

BC1 This Basis for Conclusions summarises the IASB's considerations in developing IFRS 16 *Leases*. It includes the reasons for accepting particular views and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2 IFRS 16 is also accompanied by an Effects Analysis. The Effects Analysis describes the likely costs and benefits of IFRS 16, which the IASB has prepared based on insight gained through the exposure of proposals and feedback on these proposals, and through the IASB's analysis and consultation with stakeholders.

Overview

Why the need to change previous accounting?

BC3 The previous accounting model for leases required lessees and lessors to classify their leases as either finance leases or operating leases and to account for those two types of leases differently. It did not require lessees to recognise assets and liabilities arising from operating leases, but it did require lessees to recognise assets and liabilities arising from finance leases. The IASB, together with the US national standard-setter, the Financial Accounting Standards Board (FASB) (together 'the Boards'), initiated a joint project to improve the financial reporting of leasing activities under IFRS and US Generally Accepted Accounting Principles (US GAAP) in the light of criticisms that the previous accounting model for leases failed to meet the needs of users of financial statements. In particular:

(a) information reported about operating leases lacked transparency and did not meet the needs of users of financial statements. Many users adjusted a lessee's financial statements to capitalise operating leases because, in their view, the financing and assets provided by leases should be reflected on the statement of financial position ('balance sheet'). Some tried to estimate the present value of future lease payments. However, because of the limited information that was available, many used techniques such as multiplying the annual lease expense by eight to estimate, for example, total leverage and the capital employed in operations. Other users were unable to make adjustments—they relied on data sources such as data aggregators when screening potential investments or making investment decisions. These different approaches created information asymmetry in the market.

(b) the existence of two different accounting models for leases, in which assets and liabilities associated with leases were not recognised for operating leases but were recognised for finance leases, meant that transactions that were economically similar could be accounted for very differently. The differences reduced comparability for users of financial statements and provided opportunities to structure transactions to achieve a particular accounting outcome.

(c) the previous requirements for lessors did not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from the lessor's retained interest in the underlying asset), particularly for leases of equipment and vehicles that were classified as operating leases.

BC4 The Boards decided to address the first two criticisms by developing a new approach to lessee accounting that requires a lessee to recognise assets and liabilities for the rights and obligations created by leases. IFRS 16 requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months and for which the underlying asset is not of low value. The IASB concluded that such an approach will result in a more faithful representation of a lessee's assets and liabilities and, together with enhanced disclosures, greater transparency of a lessee's financial leverage and capital employed. To address the third criticism, IFRS 16 requires enhanced disclosure by lessors of information about their risk exposure.

Background

BC5 In March 2009 the Boards published a joint Discussion Paper *Leases: Preliminary Views*. The Discussion Paper set out the Boards' preliminary views on lessee accounting, proposing a 'right-of-use' accounting model. Feedback on the Discussion Paper generally supported the 'right-of-use' model for lessees, by which a lessee would recognise a right-of-use asset and a lease liability at the commencement date of the lease. The Discussion Paper did not discuss lessor accounting in any detail.

BC6 In August 2010 the Boards published a joint Exposure Draft *Leases* (the '2010 Exposure Draft'). The Boards developed the 2010 Exposure Draft after considering the comment letters received on the Discussion Paper, as well as input obtained from their Lease Accounting Working Group and from others who were interested in the financial reporting of leases. The 2010 Exposure Draft:

(a) further developed the 'right-of-use' accounting model for lessees that had been proposed in the Discussion Paper, and that respondents had generally supported.

(b) added proposals for changes to lessor accounting. The Boards decided to include lessor accounting in the proposals in response to comments from respondents to the Discussion Paper. Some respondents had recommended that the Boards develop accounting models for lessees and lessors on the basis of a consistent rationale. The Boards also saw merit in developing lessor accounting proposals at the same time as they were developing proposals for recognising revenue (which the IASB subsequently finalised in IFRS 15 *Revenue from Contracts with Customers*).

BC7 For lessors, the 2010 Exposure Draft proposed a dual accounting model:

(a) for some leases, a lessor would apply a 'performance obligation' approach. Applying this approach, a lessor would recognise a lease receivable and a liability at the commencement date, and would also continue to recognise the underlying asset.

(b) for other leases, a lessor would apply a 'derecognition' approach. Applying this approach, a lessor would derecognise the underlying asset, and recognise a lease receivable and any retained interest in the underlying asset (a 'residual asset') at the commencement date.

BC8 The 2010 Exposure Draft also included detailed proposals on the measurement of the lessee's lease liability and the lessor's lease receivable. Of particular note was its proposal that in estimating the lease payments, a lessee should:

(a) assume the longest possible term that was more likely than not to occur, taking into account any options to extend or terminate the lease; and

(b) include an estimate of variable lease payments, if those payments could be measured reliably.

BC9 The Boards received 786 comment letters in response to the 2010 Exposure Draft. The Boards also conducted extensive outreach on the proposals in the 2010 Exposure Draft. Round table discussions were held in Hong Kong, the United Kingdom and the United States. Workshops were organised in Australia, Brazil, Canada, Japan, South Korea, the UK and the US. Members of the Boards also participated in conferences, working group meetings, discussion forums, and one-to-one discussions that were held across all major geographical regions. In 2011 and 2012, while redeliberating the proposals in the 2010 Exposure Draft, the Boards conducted additional targeted outreach with more than 100 organisations. The purpose of the targeted outreach was to obtain additional feedback to assist the Boards in developing particular aspects of the revised proposals. The targeted outreach meetings involved international working group members, representatives from accounting firms, local standard-setters, users and preparers of financial statements, particularly those from industries most affected by the lease accounting proposals.

BC10 Responses to the 2010 Exposure Draft indicated that:

(a) there was general support for lessees recognising assets and liabilities arising from a lease. That support was consistent with comments received on the Discussion Paper.

(b) there were mixed views on the effects of the proposed right-of-use model on a lessee's profit or loss. The effect was that a lessee would recognise two separate expenses in its statement of profit or loss and other comprehensive income ('income statement')—depreciation of the right-of-use asset and interest on the lease liability. Some respondents supported the identification of two separate expenses, on the grounds that leases are a source of finance for a lessee and should be accounted for accordingly. However, others did not support these effects because they thought that they would not properly reflect the economics of all lease transactions. In particular, some respondents referred to shorter-term property leases as examples of leases that, in their view, were not financing transactions from either the lessee's or lessor's perspective.

(c) many respondents disagreed with the proposals for lessor accounting:

(i) some respondents were concerned that the dual accounting model proposed for lessors was not consistent with the single accounting model proposed for lessees.

(ii) many respondents opposed the performance obligation approach. In the view of those respondents, the approach would artificially inflate a lessor's assets and liabilities.

(iii) some respondents recommended applying the derecognition approach to all leases. However, many disagreed with the proposal to prevent a lessor from accounting for the effects of the time value of money on the residual asset.

(iv) some respondents thought that the lessor accounting requirements in IAS 17 *Leases* and FASB Topic 840 *Leases* work well in practice and supported retaining those requirements.

(d) almost all respondents were concerned about the cost and complexity of the proposals, in particular the proposals regarding the measurement of the lessee's lease liability and the lessor's lease receivable. Some questioned whether lease payments to be made during optional extension periods would meet the definition of an asset (for the lessor) or a liability (for the lessee). Others suggested that it would be extremely difficult in many cases to estimate variable lease payments if the amounts depended on future sales or use of the underlying asset and that such estimates would be subject to a high level of measurement uncertainty. Many expressed a view that, because of the amount of judgement involved, the cost of including variable lease payments and payments to be made during optional periods in the measurement of lease assets and lease liabilities would outweigh the benefit for users of financial statements.

(e) many respondents also were concerned about the breadth of the scope of the proposals, indicating that the proposed definition of a lease had the potential to capture some contracts that they considered to be for services.

BC11 The Boards considered the feedback received on the 2010 Exposure Draft and observed that it would not be possible to reflect the views of all stakeholders because stakeholders did not have a united view of the economics of leases. However, in response to views that the economics of leases can be different the Boards decided to develop a revised model that identified two classes of leases and specified different requirements for each type. The classification depended on the extent to which the lessee was expected to consume the economic benefits embedded in the underlying asset.

BC12 Consequently, in May 2013 the Boards published a second joint Exposure Draft *Leases* (the '2013 Exposure Draft'). The 2013 Exposure Draft proposed:

(a) for lessees, simpler measurement requirements and a dual approach for the recognition and measurement of expenses related to a lease:

(i) for leases for which the lessee was expected to consume more than an insignificant amount of the economic benefits embedded in the underlying asset, a lessee would apply an approach similar to that proposed in the 2010 Exposure Draft, ie recognise depreciation of the right-of-use asset and interest on the lease liability separately in the income statement.

(ii) for leases for which the lessee was expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset, a lessee would recognise a single lease expense in the income statement. This approach was based on the view that a single lease expense would provide better information about leases for which the lessee in essence is paying mainly for the use of the underlying asset and is expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset itself.

(b) for lessors, a dual approach for the recognition and measurement of lease assets:

(i) for leases for which the lessee was expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, a lessor would recognise its residual interest in the underlying asset separately from its receivable from the lessee.

(ii) for other leases, a lessor would recognise the underlying asset, ie apply requirements similar to those in IAS 17 for operating leases.

BC13 The Boards received 641 comment letters in response to the 2013 Exposure Draft. In addition, the Boards conducted extensive outreach on the proposals in the 2013 Exposure Draft, including:

(a) consultations with over 270 users of financial statements based in Australia, Belgium, Canada, France, Hong Kong, Japan, the Netherlands, New Zealand, Sweden, Switzerland, the UK and the US;

(b) fieldwork meetings with individual preparers of financial statements from various industries including consumer goods, retail, aviation, oil and gas, telecommunications and automotive industries. These meetings were held in Brazil, France, Germany, Japan, Spain, the UK and the US and included detailed discussions about the costs of implementation for those entities.

(c) round table discussion held in London, Los Angeles, Norwalk, São Paulo and Singapore. These discussions were attended by approximately 100 stakeholder representatives.

(d) meetings with the IASB's advisory bodies—the Capital Markets Advisory Committee, the Global Preparers Forum, the IFRS Advisory Council and the Accounting Standards Advisory Forum.

(e) outreach meetings with various other individual preparers and groups of preparers, standard-setters and regulators. These meetings included presentations during accounting conferences and at industry forums, and meetings with individual organisations or groups.

(f) project webcasts that attracted over 2,000 participants.

BC14 The feedback received on the proposals in the 2013 Exposure Draft indicated that:

(a) consistently with the views they had expressed on the 2010 Exposure Draft, many stakeholders supported the recognition of a right-of-use asset and a lease liability by a lessee for all leases of more than 12 months in duration. These stakeholders included the majority of users of financial statements consulted, who were of the view that the proposed recognition of assets and liabilities by a lessee would provide them with a better starting point for their analyses.

(b) nonetheless, many stakeholders had significant concerns about the proposed lessee accounting model. Some were of the view that the previous lessee accounting model in IAS 17 did not need to be changed, or that deficiencies in that model could be rectified by improving the disclosure requirements, instead of changing the recognition and measurement requirements. Others disagreed with one or more specific aspects of the proposed lessee accounting model, such as the proposed dual approach or the proposal to periodically reassess the measurement of lease assets and lease liabilities.

(c) many stakeholders thought that the measurement proposals in the 2013 Exposure Draft represented a significant improvement over the proposals in the 2010 Exposure Draft, especially relating to simplifications in respect of variable lease payments and payments under renewal and purchase options. Nonetheless, the majority of stakeholders still had concerns about the cost and complexity of the proposals in the 2013 Exposure Draft. Specific areas of the proposals that stakeholders highlighted as being particularly costly or complex included the dual lessee and lessor accounting models (both the lease classification proposals and the accounting requirements), the reassessment proposals, the disclosure proposals and the scope of the transactions subject to the proposals.

(d) the majority of stakeholders disagreed with the proposed lessor accounting model. Most of these stakeholders were of the view that the previous lessor accounting model in IAS 17 was not fundamentally flawed and should not be changed.

BC15 The Boards considered the feedback they had received in response to the different models proposed in the 2010 and 2013 Exposure Drafts. The Boards confirmed their previous decision that a lessee should be required to recognise right-of-use assets and lease liabilities for all leases (with limited exceptions). However, the Boards reached different decisions with respect to the expense recognition model. For the reasons described in paragraphs BC41–BC56, the IASB decided to adopt a single lessee accounting model in which a lessee would account for all leases as providing finance. In the light of all of the feedback received, the IASB is of the view that this model provides the most useful information to the broadest range of users of financial statements. The IASB thinks that the model also addresses many of the concerns raised by stakeholders about cost and complexity, and the concerns raised about the conceptual basis of the dual model proposed in the 2013 Exposure Draft (see paragraph BC45). In contrast, the FASB decided to adopt a dual lessee expense recognition model, classifying leases in a similar manner to the previous US GAAP requirements for distinguishing between operating leases and capital leases. In making these decisions, the Boards observed that, for lessees with a portfolio of leases starting and ending at different times, any difference in reported profit or loss between IFRS and US GAAP is not expected to be significant for many lessees.

BC16 There are a number of other differences between IFRS 16 and the decisions made by the FASB, mainly because of the different decisions reached on the lessee accounting model. This Basis for Conclusions summarises only the reasons for decisions made by the IASB and reflected in IFRS 16. Paragraphs BC303–BC310 summarise the differences between IFRS 16 and the decisions made by the FASB.

BC17 In response to feedback received, the IASB and the FASB also decided to substantially carry forward the lessor accounting requirements in IAS 17 and Topic 840 respectively.

BC18 IFRS 16 addresses many of the concerns raised by stakeholders about the cost and complexity of the proposals in the 2010 and 2013 Exposure Drafts. In addition to the single lessee accounting model, which removes the need for lessees to classify leases, and the decision to substantially carry forward the lessor accounting requirements in IAS 17, the IASB decided to:

(a) permit a lessee not to recognise assets and liabilities for short-term leases and leases of low-value assets;

(b) confirm that an entity may apply the Standard at a portfolio level for leases with similar characteristics;

(c) further simplify the measurement requirements for lease liabilities, in particular the requirements for variable lease payments, payments during optional periods and the reassessment of lease liabilities;

(d) simplify the requirements for separating lease and non-lease components of a contract;

(e) change the lessee disclosure requirements to enable lessees to more effectively focus disclosures on the most significant features of their lease portfolios; and

(f) simplify the lessee transition requirements.

The approach to lease accounting

BC19 All contracts create rights and obligations for the parties to the contract. Lessee accounting in IFRS 16 considers the rights and obligations created by a lease from the perspective of the lessee. As discussed further in paragraphs

BC105–BC126, a lease is defined as a 'contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. The lessee accounting model in IFRS 16 reflects the economics of a lease because, at the commencement date, a lessee obtains the right to use an underlying asset for a period of time, and the lessor has delivered that right by making the asset available for use by the lessee.

BC20 A lessee has the right to use an underlying asset during the lease term and an obligation to make payments to the lessor for providing the right to use that asset. The lessee also has an obligation to return the underlying asset in a specified condition to the lessor at the end of the lease term. The lessor has a right to receive payments from the lessee for providing the right to use the underlying asset. The lessor also retains rights associated with ownership of the underlying asset.

BC21 Having identified the rights and obligations that arise from a lease, the IASB considered which of those rights and obligations create assets and liabilities for the lessee and lessor.

Rights and obligations arising from a lease that create assets and liabilities for the lessee

Right to use an underlying asset

BC22 The IASB's *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) defines an asset as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. The IASB concluded that a lessee's right to use an underlying asset meets the definition of an asset for the following reasons:

(a) the lessee controls the right to use the underlying asset throughout the lease term. Once the asset is made available for use by the lessee, the lessor is unable to retrieve or otherwise use the underlying asset for its own purposes during the lease term, despite being the legal owner of the underlying asset.

(b) the lessee has the ability to determine how to use the underlying asset and, thus, how it generates future economic benefits from that right of use. This ability demonstrates the lessee's control of the right of use. For example, suppose a lessee leases a truck for four years, for up to a maximum of 160,000 miles over the lease term. Embedded in the right to use the truck is a particular volume of economic benefits or service potential that is used up over the period that the truck is driven by the lessee. After the truck is made available for use by the lessee, the lessee can decide how it wishes to use up or consume the economic benefits embedded in its right of use within the parameters defined in the contract. The lessee could decide to drive the truck constantly during the first three years of the lease, consuming all of the economic benefits in those first three years. Alternatively, it could use the truck only during particular months in each year or decide to use it evenly over the four-year lease term.

(c) the right to control and use the asset exists even when a lessee's right to use an asset includes some restrictions on its use. Although restrictions may affect the value and scope of a lessee's right to use an asset (and thus the payments made for the right of use), they do not affect the existence of the right-of-use asset. It is not unusual for restrictions to be placed on the use of owned assets as well as leased assets. For example, assets acquired from a competitor may be subject to restrictions on where they can be used, how they can be used or to whom they can be sold; assets that are used as security for particular borrowings may have restrictions placed on their use by the lender; or a government may place restrictions on the use or transfer of assets in a particular region for environmental or security reasons. Those restrictions do not necessarily result in the owner of such assets failing to control those assets—the restrictions may simply affect the economic benefits that will flow to the entity from the asset and that will be reflected in the price that the entity is willing to pay for the asset. Similarly, such restrictions do not prevent a lessee from controlling a right-of-use asset.

(d) the lessee's control of the right of use arises from past events—not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee for the duration of the non-cancellable period of the lease. Some have noted that the lessee's right to use an asset is conditional on the lessee making payments during the lease term, ie that the lessee may forfeit its right to use the asset if it does not make payments. However, unless the lessee breaches the contract, the lessee has an unconditional right to use the underlying asset. Its position is similar to that of an entity that had made an instalment purchase and has not yet made the instalment payments.

BC23 The IASB also considered the proposed definition of an asset in the May 2015 Exposure Draft *The Conceptual Framework for Financial Reporting* (the '*Conceptual Framework* Exposure Draft'). That exposure draft proposes to define an asset as 'a present economic resource controlled by the entity as a result of past events' and defines an economic resource as 'a right that has the potential to produce economic benefits'. In the IASB's view, a lessee's right to use an underlying asset would meet this proposed definition of an asset, for the reasons described in paragraph BC22.

BC24 Consequently, the IASB concluded that the lessee's right to use an underlying asset meets both the existing and proposed definitions of an asset.

Obligation to make lease payments

BC25 The *Conceptual Framework* defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. The IASB concluded that the lessee's obligation to make lease payments meets the definition of a liability for the following reasons:

(a) the lessee has a present obligation to make lease payments once the underlying asset has been made available to the lessee. That obligation arises from past events—not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee. Unless the lessee renegotiates the lease, the lessee has no right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term.

(b) the obligation results in a future outflow of economic benefits from the lessee—typically contractual cash payments in accordance with the terms and conditions of the lease.

BC26 The IASB also considered the *Conceptual Framework* Exposure Draft, which proposes to define a liability as 'a present obligation of the entity to transfer an economic resource as a result of past events'. In the IASB's view, a lessee's obligation to make lease payments would also meet this definition of a liability for the reasons described in paragraph BC25.

BC27 Consequently, the IASB concluded that a lessee's obligation to make lease payments meets both the existing and proposed definitions of a liability.

Obligation to return the underlying asset to the lessor

BC28 The lessee controls the use of the underlying asset during the lease term, and has an obligation to return the underlying asset to the lessor at the end of the lease term. That obligation is a present obligation that arises from past events (the underlying asset being made available for use by the lessee under the terms of the lease contract).

BC29 Some are of the view that there is an outflow of economic benefits at the end of the lease term because the lessee must surrender the underlying asset, which will frequently still have some potential to generate economic benefits. However, in the IASB's view, there is no outflow of economic benefits (other than incidental costs) from the lessee when it returns the leased item, because the lessee does not control the economic benefits associated with the asset that it returns to the lessor. Even if the lessee has physical possession of the underlying asset, it has no right to obtain the remaining economic benefits associated with the underlying asset once the lease term expires (ignoring any options to extend the lease or purchase the underlying asset). Once it reaches the end of the lease term, the position of the lessee is like that of an asset custodian. The lessee is holding an asset on behalf of a third party, the lessor, but has no right to the economic benefits embodied in that asset at the end of the lease term.

BC30 Consequently, the IASB concluded that the lessee's obligation to return the underlying asset does not meet the definition of a liability in the *Conceptual Framework*. The IASB is of the view that the changes proposed to the definition of a liability in the *Conceptual Framework* Exposure Draft would not affect this conclusion.

BC31 Having considered whether the lessee's right to use an underlying asset, obligation to make lease payments and obligation to return the underlying asset meet the definition of an asset or a liability, the IASB considered the lessee accounting model. This is discussed in paragraphs BC41–BC56.

Why leases are different from service contracts for the lessee

BC32 The IASB concluded that leases create rights and obligations that are different from those that arise from service contracts. This is because, as described in paragraph BC22, the lessee obtains and controls the right-of-use asset at the time that the underlying asset is made available for use by the lessee.

BC33 When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee now controls that right of use. Consequently, the lessee has an unconditional obligation to pay for that right of use.

BC34 In contrast, in a typical service contract, the customer does not obtain an asset that it controls at commencement of the contract. Instead, the customer obtains the service only at the time that the service is performed. Consequently, the customer typically has an unconditional obligation to pay only for the services provided to date. In addition, although fulfilment of a service contract will often require the use of assets, fulfilment typically does not require making those assets available for use by the customer throughout the contractual term.

Rights and obligations arising from a lease that create assets and liabilities for the lessor

Lease receivable

BC35 When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee controls the right of use. Accordingly, the lessor has an unconditional right to receive lease payments (the lease receivable). The lessor controls that right—for example, it can decide to sell or securitise that right. The right arises from past events (not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee) and is expected to result in future economic benefits (typically cash from the lessee) flowing to the lessor.

BC36 Consequently, the IASB concluded that the lessor's lease receivable meets the definition of an asset in the *Conceptual Framework*. The IASB is of the view that the changes proposed to the definition of an asset in the *Conceptual Framework* Exposure Draft would not affect this conclusion.

Rights retained in the underlying asset

BC37 Although the lessor transfers the right to use the underlying asset to the lessee at the commencement date, the lessor has the right to the underlying asset at the end of the lease term (and retains some rights to the underlying asset during the lease term; for example, the lessor retains title to the asset). Consequently, the lessor retains some of the potential economic benefits embedded in the underlying asset.

BC38 The lessor controls the rights that it retains in the underlying asset. A lessor can often, for example, sell the underlying asset (with the lease attached) or agree at any time during the initial lease term to sell or re-lease the underlying asset at the end of the lease term. The lessor's rights to the underlying asset arise from a past event—the purchase of the underlying asset or commitment to a head lease, if the lessor subleases the asset. Future economic benefits from the lessor's retained rights in the underlying asset are expected to flow to the lessor, assuming that the lease is for anything other than the full economic life of the underlying asset. The lessor would expect to obtain economic benefits either from the sale, re-lease or use of the underlying asset at the end of the lease term.

BC39 Consequently, the IASB concluded that the lessor's rights retained in the underlying asset meet the definition of an asset in the *Conceptual Framework*. The IASB is of the view that the changes proposed to the definition of an asset in the *Conceptual Framework* Exposure Draft would not affect this conclusion.

BC40 Having considered whether the lessor's lease receivable and rights retained in the underlying asset meet the definition of an asset, the IASB considered the lessor accounting model. This is discussed in paragraphs BC57–BC66.

The lessee accounting model

BC41 Having concluded that the lessee's right to use the underlying asset meets the definition of an asset and the lessee's obligation to make lease payments meets the definition of a liability (as described in paragraphs BC22–BC40), the IASB then considered whether requiring a lessee to recognise that asset and liability for all leases would improve financial reporting to the extent that the benefits from the improvements would outweigh the costs associated with such a change.

BC42 The IASB considered comments from respondents to the Discussion Paper and the 2010 and 2013 Exposure Drafts, and from participants at consultation meetings (including meetings with users of financial statements) as described in paragraphs BC9 and BC13. In the light of these comments, the IASB concluded that there would be significant benefits from requiring a lessee to recognise right-of-use assets and lease liabilities for all leases (except short-term leases and leases of low-value assets as described in paragraphs BC87–BC104), particularly for users of financial statements and others who have raised concerns about the extent of off balance sheet financing provided through operating leases.

BC43 The IASB considered the costs associated with requiring a lessee to recognise right-of-use assets and lease liabilities for all leases throughout its redeliberations. In the light of comments from respondents to the 2010 and 2013 Exposure Drafts, IFRS 16 contains a number of simplifications and practical expedients to address concerns about costs. The costs and benefits of the lessee accounting model are discussed extensively in the Effects Analysis.

BC44 The IASB also consulted extensively on the approach to the recognition of lease expenses. The feedback from that consultation emphasised that different stakeholders have different views about the economics of lease transactions. Some view all leases as providing finance. Some view almost no leases as providing finance. Others think that the economics are different for different leases.

BC45 The 2010 Exposure Draft proposed a single lessee expense recognition model that was based on the premise that all leases provide finance to the lessee. The

IASB received a significant amount of feedback in response to the 2010 Exposure Draft with stakeholders expressing differing views. In the light of this feedback, the IASB decided to expose for comment an alternative lessee expense recognition model—a dual model—that was responsive to those stakeholders who thought that a dual model would provide more useful information than a single model. Applying the dual model proposed in the 2013 Exposure Draft, leases would have been classified based upon the extent to which the lessee was expected to consume the economic benefits embedded in the underlying asset. Although some stakeholders supported that model, the feedback received in response to the proposals reiterated the mixed views that had been received throughout the project regarding lessee accounting. In particular:

(a) some stakeholders, including most users of financial statements, were of the view that all leases provide finance to lessees and, thus, create assets and 'debt-like' liabilities. Consequently, they supported a single lessee expense recognition model according to which a lessee would recognise interest on those debt-like liabilities separately from depreciation of lease assets for all leases.

(b) some were of the view that a lessee receives equal benefits from use of the underlying asset in each period and pays equal amounts for that benefit. Consequently, they supported a single lessee expense recognition model in which a lessee would allocate the total cost of the lease to each period on a straight-line basis to reflect the pattern in which the lessee consumes benefits from use of the underlying asset. These stakeholders also noted that a decision to lease assets rather than purchase them is sometimes made in order to obtain operational flexibility (rather than to obtain finance). Consequently, they were of the view that a single straight-line lease expense would be a more faithful representation of the transaction in the income statement.

(c) some supported a single lessee expense recognition model because they had concerns about the cost and complexity of a dual expense recognition model. They noted the administrative benefits of removing the need for a lease classification test and having only one method of accounting for all leases. They also questioned whether more than one expense recognition pattern would provide useful information to users of financial statements.

(d) some supported a single lessee expense recognition model for conceptual reasons. They thought that, if all leases are recognised on a lessee's balance sheet, any attempt to differentiate between those leases in the income statement would be arbitrary and result in inconsistencies with the accounting for a non-financial asset and a financial liability in the balance sheet. Many also criticised the accounting that would result from a dual model that required the recognition of assets and liabilities together with a single, straight-line lease expense (as was proposed for some leases in the 2013 Exposure Draft). This is because, under that model, the right-of-use asset would have been measured as a balancing figure.

(e) some stakeholders noted that any dual model perpetuates the risk of structuring to gain a particular accounting outcome.

(f) some stakeholders thought that there are real economic differences between different leases, particularly between property leases and leases of assets other than property. These stakeholders recommended a dual lessee expense recognition model in which a lessee would recognise a single, straight-line lease expense for most property leases. They recommended such a model because they view property lease expenses as an important part of operating expenses, particularly for entities such as retailers, hoteliers and restaurateurs.

(g) some stakeholders recommended retaining a dual model that classified leases using the classification principle in IAS 17. They thought that recognition of a single, straight-line lease expense for all leases previously classified as operating leases would appropriately reflect the benefit that the lessee receives evenly over the lease term. This accounting would also align the lease expense more closely with lease payments, which some stakeholders viewed as preferable.

BC46 The IASB also consulted many users of financial statements (see paragraphs BC9 and BC13). Most users consulted (including almost all of those who analyse industrial, airline, transport and telecommunications sectors) were of the view that leases create assets and 'debt-like' liabilities. Consequently, they thought that recognising interest on lease liabilities separately from depreciation of right-of-use assets would be beneficial to their analyses, particularly in assessing the operating performance of an entity. The separate recognition of those expenses would be particularly beneficial for those users of financial statements who use reported information for their analyses without making further adjustments—it would create greater comparability in the income statement between entities that borrow to buy assets and those that lease similar assets. Separating interest and depreciation would also provide coherency between the lessee's balance sheet and income statement (ie the interest expense would correspond to the lease liabilities presented as financial liabilities, and depreciation would correspond to the right-of-use assets presented as non-financial assets). This coherency is important for some analyses, such as calculating return on capital employed and some leverage ratios.

BC47 Credit analysts consulted were generally of the view that all leases create assets and 'debt-like' liabilities for lessees. Consequently, they saw benefit in recognising interest on lease liabilities separately from depreciation of right-of-use assets. Many of those credit analysts already adjust a lessee's income statement for operating leases to estimate an allocation of operating lease expense between depreciation and interest.

BC48 Most users of the financial statements of retailers, hoteliers and restaurateurs (ie those entities that typically have significant amounts of leased property) expressed support for a model that would recognise a single lease expense for property leases. Some of those users view leases of property as executory contracts. For them, a single lease expense recognised within operating expenses would have best satisfied their needs. However, other users of the financial statements of retailers, hoteliers and restaurateurs had estimated an allocation of operating lease expense between depreciation and interest in their analyses based on previous lessee accounting requirements. Consequently, those users thought that requiring a lessee to recognise interest on lease liabilities separately from depreciation of right-of-use assets would provide them with information that is useful for their analyses.

BC49 The IASB also considered the adjustments made by those lessees that, in applying the previous lessee accounting requirements, reported lease-adjusted ‘non-GAAP’ information alongside their financial statements. These lessees often reported ratios based on amounts in the balance sheet, income statement and statement of cash flows that were adjusted to reflect the amounts that would have been reported if operating leases were accounted for as financing transactions (as is required by IFRS 16). For example, a commonly reported amount was lease-adjusted return on capital employed which was often calculated as (a) operating profit adjusted for the estimated interest on operating leases; divided by (b) reported equity plus financial liabilities adjusted to include liabilities for operating leases.

BC50 The IASB also observed that the consequence of any model that requires both the recognition of right-of-use assets and lease liabilities in the balance sheet together with a single, straight-line lease expense in the income statement (as was proposed for some leases in the 2013 Exposure Draft) would be a lack of coherency between the primary financial statements. In particular, any such model:

(a) would result in a lessee recognising a financial liability in the balance sheet without presenting a commensurate interest expense in the income statement. Similarly, a lessee would recognise a non-financial asset without any commensurate depreciation in the income statement. These inconsistencies could distort ratio analyses performed on the basis of the amounts reported in the primary financial statements.

(b) would require either the right-of-use asset or the lease liability to be measured as a balancing figure. This is because measuring (i) the right-of-use asset on the basis of cost less accumulated depreciation and impairment; and (ii) the lease liability using an effective interest method would generally not result in a straight-line lease expense.

BC51 Consequently, the IASB concluded that:

(a) a lessee model that separately presents depreciation and interest for all leases recognised in the balance sheet provides information that is useful to the broadest range of users of financial statements. The IASB reached this conclusion for three main reasons:

(i) most users of financial statements consulted think that leases create assets and ‘debt-like’ liabilities for a lessee. Consequently, they benefit from lessees recognising interest on those liabilities in a similar way to interest on other financial liabilities, because that enables them to perform meaningful ratio analyses. The same is true regarding the recognition of depreciation of right-of-use assets in a similar way to depreciation of other non-financial assets such as property, plant and equipment. The model is particularly beneficial for those users that rely on reported information without making adjustments.

(ii) the model is easy to understand—a lessee recognises assets and financial liabilities, and corresponding amounts of depreciation and interest.

(iii) the model addresses the concern of some users of financial statements that a dual model would perpetuate the risk of structuring to create a particular accounting outcome.

(b) accounting for all leases recognised in the balance sheet in the same way appropriately reflects the fact that all leases result in a lessee obtaining the right to use an asset, regardless of the nature or remaining life of the underlying asset.

(c) a single model reduces cost and complexity by removing the need to classify leases and the need for systems that can deal with two lessee accounting approaches.

BC52 In reaching its decisions relating to the lessee expense recognition model, the IASB observed that much of the negative feedback received in response to the single model proposed in the 2010 Exposure Draft related to the proposed measurement of lease assets and lease liabilities—in particular, the requirements for a lessee to estimate future variable lease payments and to determine the lease term based on the longest possible term that was more likely than not to occur. The measurement proposals for variable lease payments and optional lease periods were simplified in the 2013 Exposure Draft, and these simplifications have been retained in IFRS 16. As described in paragraph BC18, the IASB also introduced a number of further simplifications and exemptions after considering feedback on the 2013 Exposure Draft. The IASB expects the simpler measurement requirements and exemptions in IFRS 16 to alleviate many of the concerns that were received in response to the single model proposed in the 2010 Exposure Draft.

BC53 Consequently, the IASB decided to require a single lessee accounting model for all leases recognised in a lessee's balance sheet. This model requires a lessee to depreciate the right-of-use asset similarly to other non-financial assets and to account for the lease liability similarly to other financial liabilities.

Other approaches considered for the lessee accounting model

BC54 The IASB also considered an approach similar to the lessee accounting requirements that have been decided upon by the FASB. Applying that approach, a lessee would generally recognise a single, straight-line lease expense for leases that would have been classified as operating leases applying IAS 17.

BC55 Most lessees that predominantly lease property supported such an approach, as did some users of financial statements that analyse entities that predominantly lease property. In the view of those lessees and users, recognising lease expenses for property leases on a straight-line basis reflects the nature of the transaction. For example, some noted that, when a lessee enters into a typical five-year lease of retail space, the lessee is simply paying to use the retail space rather than consuming any of the value of the underlying asset. In their view, a lessee should recognise these rentals on a straight-line basis.

BC56 The IASB did not adopt the approach decided upon by the FASB because, in its view:

(a) information reported under the single lessee accounting model specified in IFRS 16 would provide the most useful information to the broadest range of users of financial statements as described in paragraphs BC46–BC52; and

(b) the costs for preparers under the approach decided upon by the FASB would be broadly similar to the costs of the single lessee accounting model specified in IFRS 16. For both approaches, the most significant cost associated with a new lessee accounting model would be the cost associated with recognising and measuring right-of-use assets and lease liabilities for all leases. Although the approach decided upon by the FASB would have retained the classification requirements of IAS 17 (which are familiar to lessees), it would still have required a lessee to recognise right-of-use assets and lease liabilities on a discounted basis for all leases (with some exceptions).

The lessor accounting model

BC57 Having concluded that the lessor's lease receivable and rights retained in the underlying asset both meet the definition of an asset (as described in paragraphs BC35–BC40), the IASB considered whether requiring a lessor to recognise those assets for all leases would improve financial reporting to the extent that the benefits from the improvements would outweigh the costs associated with such a change.

BC58 The IASB considered the feedback received throughout the project regarding lessor accounting and concluded that the costs associated with making changes to lessor accounting would be difficult to justify at this time because most stakeholders (including users of financial statements) were of the view that lessor accounting in IAS 17 is not 'broken'. Consequently, the IASB decided to substantially carry forward the lessor accounting model in IAS 17.

BC59 In reaching this decision, the IASB noted that criticisms of the accounting model for leases under IAS 17 were primarily focused on lessee accounting. Consequently, when the IASB initially added the Leases project to its agenda, the project was intended to address only lessee accounting and not lessor accounting.

BC60 The IASB had earlier proposed to address lessor accounting in response to feedback received from some respondents to the Discussion Paper (as described in paragraph BC6). Those respondents had asked the IASB to address both lessee and lessor accounting at the same time because they thought that developing consistent and symmetrical accounting for lessees and lessors would be beneficial. In addition, some users of financial statements had argued that the lessor accounting model in IAS 17 did not provide sufficient information about a lessor's exposure to residual asset risk (ie the risks retained as a result of its remaining interest in the underlying asset). Accordingly, the IASB proposed changes to lessor accounting in the 2010 and 2013 Exposure Drafts that were more symmetrical with the lessee accounting model ultimately included in IFRS 16, because these proposals would have required a lessor to recognise a lease receivable for all (or many) leases.

BC61 The feedback received in response to the proposals in the 2010 and 2013 Exposure Drafts highlighted that the majority of stakeholders did not support changing the lessor accounting model in IAS 17. In particular, stakeholders observed that:

(a) the lessor accounting model in IAS 17 is well understood.

(b) most users of financial statements do not currently adjust lessors' financial statements for the effects of leases—indicating that the lessor accounting model in IAS 17 already provides users of financial statements with the information that they need. In addition, investors generally analyse the financial statements of individual entities (and not a lessee and lessor of the same underlying asset). Accordingly, it is not essential that the lessee and lessor accounting models are symmetrical.

(c) in contrast to lessee accounting, lessor accounting in IAS 17 is not fundamentally flawed and should not be changed solely because lessee accounting is changing.

BC62 Some stakeholders also acknowledged that their views on lessor accounting had changed over the life of the Leases project. These stakeholders noted that they had originally suggested that the IASB should address lessor accounting at the same time as lessee accounting. However, in response to the 2013 Exposure Draft, they suggested that no changes should be made to lessor accounting. These stakeholders had changed their views primarily for cost-benefit reasons.

BC63 In the light of this feedback, the IASB concluded that requiring a lessor to recognise a lease receivable for all leases would not improve financial reporting to the extent that the benefits from the improvements would outweigh the costs associated with such a change.

BC64 Nonetheless, the IASB decided to change selected elements of the lessor accounting model in IAS 17 in the light of the decisions made about the lessee accounting model. In particular, the IASB made changes to the accounting for subleases, the definition of a lease, initial direct costs and lessor disclosures.

BC65 Accordingly, IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17, with the exception of the definition of a lease (see paragraphs BC105–BC126), initial direct costs (see paragraph BC237) and lessor disclosures (see paragraphs BC251–BC259). IFRS 16 also includes requirements and examples on subleases (see paragraphs BC232–BC236) in the light of the new lessee accounting requirements, and includes requirements on lease modifications (see paragraphs BC238–BC240). The IASB has also incorporated into this Basis for Conclusions material from the Basis for Conclusions on IAS 17 that discusses matters relating to the lessor accounting requirements that are carried forward in IFRS 16 (see paragraphs BCZ241–BCZ250). That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references to IFRS 16 have been updated accordingly and necessary editorial changes have been made.

BC66 The IASB also decided to carry forward substantially all of the wording in IAS 17 with respect to lessor accounting. This is because any changes to the words in the Standard would have a risk of unintended consequences for lessors applying IFRS 16 and may imply that changes in application of the lessor accounting requirements were intended when that was not the case.

Scope (paragraphs 3–4)

BC67 The IASB decided that the scope of IFRS 16 should be based on the scope of the leases requirements in IAS 17. IAS 17 applies to all leases, with specified exceptions.

BC68 Accordingly, IFRS 16 contains scope exceptions for:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. IFRS 6 *Exploration for and Evaluation of Mineral Resources* specifies the accounting for rights to explore for and evaluate mineral resources.

(b) leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee. IAS 41 specifies the accounting for biological assets, other than bearer plants, which are within the scope of IAS 16. Consequently, leases of bearer plants such as orchards and vineyards held by a lessee are within the scope of IFRS 16.

(c) service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements* (see paragraph BC69).

(d) licences of intellectual property granted by a lessor within the scope of IFRS 15. There are specific requirements relating to those licences within IFRS 15.

(e) leases of intangible assets held by a lessee (see paragraphs BC70–BC71).

Service concession arrangements

BC69 The IASB decided to exclude from the scope of IFRS 16 service concession arrangements within the scope of IFRIC 12. Consistently with the conclusions in IFRIC 12, any arrangement within its scope (ie that meets the conditions in paragraph 5 of the Interpretation) does not meet the definition of a lease. This is because the operator in a service concession arrangement does not have the right to control the use of the underlying asset. For this reason, the IASB considered whether it was necessary to explicitly exclude from the scope of IFRS 16 service concession arrangements within the scope of IFRIC 12. However, such a scope exclusion had been included in IFRIC 4 *Determining whether an Arrangement contains a Lease*, and stakeholders informed the IASB that including a scope exclusion for service concession arrangements in IFRS 16 would provide clarity in this respect.

Intangible assets

BC70 IFRS 16 excludes from its scope rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. This is because these licensing agreements are accounted for applying IAS 38.

BC71 IFRS 16 also states that a lessee may, but is not required to, apply IFRS 16 to leases of other intangible assets. The IASB did not want to prevent a lessee from applying IFRS 16 to leases of intangible assets for which there are no specific requirements in other Standards. The IASB acknowledged that there is no conceptual basis for excluding leases of intangible assets from the scope of IFRS 16 for lessees. However, the IASB concluded that a separate and comprehensive review of the accounting for intangible assets should be performed before requiring leases of intangible assets to be accounted for applying the requirements of IFRS 16. Many stakeholders agreed with this approach.

Onerous contracts

BC72 The IASB decided not to specify any particular requirements in IFRS 16 for onerous contracts. The IASB made this decision because:

(a) for leases that have already commenced, no requirements are necessary. After the commencement date, an entity will appropriately reflect an onerous lease contract by applying the requirements of IFRS 16. For example, a lessee will determine and recognise any impairment of right-of-use assets applying IAS 36 *Impairment of Assets*.

(b) for leases that have not already commenced, the requirements for onerous contracts in IAS 37 *Provisions, Contingent Liabilities and Contingent Asset*s are sufficient. The requirements in IAS 37 apply to any contract (and hence any lease contract) that meets the definition of an onerous contract in that Standard.

Subleases

BC73 The IASB decided that an entity should account for leases of right-of-use assets (ie subleases) in the same way as other leases. Accordingly, subleases are within the scope of IFRS 16 (see paragraphs BC232–BC236).

Inventory

BC74 IFRS 16 does not specifically exclude leases of inventory from its scope. The term ‘leased inventory’ is sometimes used to describe purchases of non-depreciating spare parts, operating materials, and supplies that are associated with leasing another underlying asset. 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 for sale in the ordinary course of business. Accordingly, the IASB decided that a scope exclusion was not necessary.

Non-core assets

BC75 Information about assets that are not essential to the operations of an entity is sometimes of less interest to users of financial statements, because those assets are often less significant to the entity. Accordingly, some think that the costs associated with recognising and measuring the assets and liabilities arising from leases of non-core assets could outweigh the benefits to users. For example, information about assets and liabilities arising from leases of delivery vans is important to assess the operations of a delivery company, but it may not be important for materiality reasons in assessing the operations of a bank that uses vans to deliver supplies to its retail banking locations. Consequently, the IASB considered whether to exclude leases of non-core assets from IFRS 16.

BC76 Although some Board members favoured such an approach, the IASB noted that:

(a) defining 'core' and 'non-core' would be extremely difficult. For example, would office buildings used by a bank be a core asset, and would the conclusion be different if the bank has retail banking operations? Would an entity consider some offices or cars to be core assets and others non-core? If core assets were defined as those essential to the operations of an entity, it could be argued that every lease would be a lease of a core asset. Otherwise, why would an entity enter into the lease?

(b) different entities might interpret the meaning of non-core assets differently, thereby reducing comparability for users of financial statements.

(c) other Standards do not distinguish between core and non-core purchased assets. Because of this, it would be difficult to justify distinguishing a right-of-use asset relating to a core asset from one that relates to a non-core asset.

BC77 Consequently, IFRS 16 does not make any distinction in accounting on the basis of whether the underlying asset is core to an entity's operations.

Long-term leases of land

BC78 A long-term lease of land is sometimes regarded as being economically similar to the purchase of the land. Consequently, some stakeholders suggested that long-term leases of land should be excluded from the scope of IFRS 16. However, the IASB decided not to specifically exclude such leases from the scope of IFRS 16 because:

(a) there is no conceptual basis for differentiating long-term leases of land from other leases. If the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term, the contract is a lease and should be accounted for as such.

(b) for a long-term lease of land (for example, a 99-year lease), the present value of the lease payments is likely to represent substantially all of the fair value of the land. In this case, the accounting applied by the lessee will be similar to accounting for the purchase of the land. If the lessee obtains control of the land, it will account for the contract as the purchase of the land by applying IAS 16 *Property, Plant and Equipment*, rather than by applying IFRS 16.

BC79 The IASB also noted that the IFRS Interpretations Committee had received questions about distinguishing between a lease and a sale or purchase when legal title to the underlying asset is not transferred. This is discussed in paragraphs BC138–BC140.

Leases of investment property at fair value

BC80 The IASB considered whether leases of investment property measured at fair value should be excluded from the scope of IFRS 16. It considered such an exclusion because many users of the financial statements of investment property lessors informed the IASB that the requirements of IAS 40 *Investment Property* provide useful information about the leasing activities of a lessor, especially when the fair value model is used. However, the IASB concluded that a lessor of investment property should apply IAS 40 when accounting for its investment property and apply IFRS 16 when accounting for the lease. That is similar to how IAS 17 and IAS 40 interacted. Accordingly, a user of financial statements would obtain fair value information about investment property subject to operating leases, which is required by IAS 40, and information about rental income earned by the lessor, which is required by IFRS 16.

Embedded derivatives

BC81 The IASB decided to require an entity to separate from a lease any derivatives embedded in the lease (as defined in IFRS 9 *Financial Instruments*), and account for the derivatives applying IFRS 9. Nonetheless, IFRS 16 includes specific requirements for features of a lease such as options and residual value guarantees that may meet the definition of a derivative. The IASB noted that the lease accounting model in IFRS 16 was not developed with derivatives in mind and, thus, IFRS 16 would not provide an appropriate basis on which to account for derivatives. Accordingly, if derivatives embedded in leases were not accounted for separately, unrelated derivative contracts could be bundled with leases to avoid measuring the derivatives at fair value.

Portfolio application (paragraph B1)

BC82 The 2010 and 2013 Exposure Drafts would not have precluded an entity from applying the leases requirements at a portfolio level. However, many entities noted that the 2011 Exposure Draft *Revenue from Contracts with Customers* proposed guidance on applying its requirements at a portfolio level (which has subsequently been confirmed in IFRS 15). These stakeholders asked whether the absence of guidance on this subject meant that an entity would not be permitted to apply IFRS 16 at a portfolio level.

BC83 In response to these concerns, the IASB decided to add application guidance on portfolios to IFRS 16. The guidance clarifies that an entity is permitted to apply the requirements in IFRS 16 to a portfolio of leases with similar characteristics, if the entity reasonably expects that the effects on the financial statements of applying IFRS 16 to the portfolio would not differ materially from applying

IFRS 16 to the individual leases within that portfolio. This approach may be particularly useful for lessees with a large number of similar leases.

Materiality

BC84 Many lessees expressed concerns about the costs of applying the requirements in IFRS 16 to leases that are large in number but low in value, particularly when the aggregate value of those leases would have little effect on the financial statements as a whole. These lessees thought that applying the requirements of IFRS 16 to those leases would involve a significant amount of time and effort without a corresponding benefit in terms of the effect on reported information.

BC85 In the light of these concerns, the IASB considered including explicit guidance on materiality within IFRS 16—either an explicit reminder that immaterial leases are excluded from the scope of IFRS 16 or by providing clarity about how the concept of materiality in the *Conceptual Framework* and in IAS 1 *Presentation of Financial Statements* applies to leases. The IASB observed that the concept of materiality applies to leases, however, other Standards do not provide materiality guidance about particular transactions and events. The IASB also noted that applying materiality considerations to the requirements in IFRS 16 is no different from applying those considerations to the requirements of other Standards. Accordingly, the IASB decided not to provide specific guidance on materiality within IFRS 16. The IASB concluded that it would be appropriate, and consistent with other Standards, to rely on the materiality guidance in the *Conceptual Framework* and in IAS 1. Nonetheless, IFRS 16 includes some recognition exemptions as described in paragraphs BC87–BC104.

BC86 In making this decision not to include materiality guidance in IFRS 16, the IASB noted that a lessee would not be required to apply the recognition and measurement requirements in IFRS 16 if the effect of doing so would not be material to its financial statements. Similarly, if a lessee's leasing activities are material to its financial statements, but the effect of measuring lease liabilities on a discounted basis is not material, the lessee would not be required to measure its lease liabilities on a discounted basis and could instead, for example, measure them on an undiscounted basis.

Recognition exemptions (paragraphs 5–8)

Short-term leases

BC87 The IASB concluded that the benefits of requiring a lessee to apply all of the requirements in IFRS 16 to short-term leases do not outweigh the associated costs. In considering how to reduce the costs for lessees, the IASB considered both the nature and the scope of a possible exemption.

Nature of the exemption

BC88 The IASB considered simplifying the measurement requirements for short-term leases. Specifically, it considered exempting lessees from the requirement to discount the payments used to measure the assets and liabilities arising from short-term leases. Many stakeholders, however, thought that this exemption would provide insufficient cost relief for lessees because it would still require an entity to track a possibly large volume of leases of a low value.

BC89 The IASB concluded that, even with simplified measurement requirements, the benefits of requiring a lessee to recognise right-of-use assets and lease liabilities for short-term leases would not outweigh the associated costs. Consequently, paragraph 5(a) of IFRS 16 permits a lessee to elect not to apply the recognition requirements to short-term leases. Instead, a lessee can recognise the lease payments associated with short-term leases as an expense over the lease term, typically on a straight-line basis. The IASB decided that this choice should be made by class of underlying asset.

BC90 In the light of the feedback that an exemption for short-term leases did not provide sufficient relief for leases of low-value assets, the IASB also developed a separate exemption for those leases (see paragraphs BC98–BC104).

Definition of 'short-term'

BC91 The IASB first considered defining a short-term lease as a lease that, at the commencement date, has a maximum possible term of 12 months or less. However, many stakeholders thought that a short-term lease exemption defined in this way would provide limited cost relief for lessees. These stakeholders noted that, in their experience, a lease rarely has a maximum possible term of 12 months or less. For example, stakeholders suggested that many leases that run month-to-month would not qualify for the exemption.

BC92 In the light of these comments, the IASB considered expanding the short-term lease exemption to leases of more than 12 months. Some stakeholders had suggested that 'short-term' should be up to five years. The IASB, however, did not adopt this approach because, for example, three-year leases are more likely to give rise to material assets and liabilities than 12 month leases, and the objective of the project was to ensure greater transparency about an entity's leasing activities.

BC93 Instead, the IASB decided to expand the short-term lease exemption by making the determination of duration of short-term leases consistent with the determination of lease term, thus considering the likelihood of extension options being exercised or termination options not being exercised (see paragraphs BC152–BC159). Accordingly, IFRS 16 defines a short-term lease as a lease that, at the commencement date, has a lease term of 12 months or less.

BC94 In reaching this decision, the IASB considered the risk that leases could be structured to meet the short-term lease exemption. The IASB concluded that this risk is mitigated by the economic consequences of a short-term lease for a lessor. There would often be an economic disincentive for lessors to grant shorter term leases, because shortening the lease term would increase the risk associated with a lessor's residual interest in the underlying asset. Consequently, the IASB is of the view that a lessor would often either demand increased lease payments from the lessee to compensate for this change in risk or refuse to shorten the non-cancellable period of the lease. In addition, the IASB noted the rigour that lessees are expected to apply when determining the lease term, as described in paragraphs B37–B40 of IFRS 16. This should reduce the risk of non-substantive break clauses being inserted within contracts solely for accounting purposes. The IASB also decided that a lessee should reassess the lease term of a short-term lease by treating it as a new lease if that lease term changes.

BC95 The IASB observed that little incremental information would be lost by defining short-term leases by reference to the IFRS 16 determination of lease term, instead of the maximum possible term. That is because a lessee would include only lease payments for the duration of the lease term as an asset and a liability, irrespective of the maximum possible term. For example, for a lease with an extension option after six months which the lessee is not reasonably certain to exercise, the lease term is six months. If that lease were not captured by the short-term lease exemption (because the maximum term is longer than the lease term), the lessee would include only lease payments for the six-month lease term in measuring the asset and liability. Consequently, by aligning the determination of short-term with the determination of lease term, the only incremental change in information would be that the lessee would no longer reflect the six months of lease payments on its balance sheet.

BC96 The IASB also considered whether identifying short-term leases using the IFRS 16 determination of lease term would be more complex to apply, because more judgement would be needed to identify that lease term than the maximum term. However, on the basis of feedback received, the IASB concluded that any additional complexity in determining the lease term would be more than compensated for by the additional cost relief provided overall as a result of:

(a) applying the exemption to a wider group of leases; and

(b) requiring lessees to perform only one assessment of lease term for the purposes of both identifying whether the lease is a short-term lease and measuring the assets and liabilities for leases that are not short-term.

BC97 The IASB also decided to require a lessee to disclose the expense related to short-term leases for which the lessee has elected to apply the short-term lease exemption (see paragraph 53(c) of IFRS 16 and paragraph BC217(c)). In the IASB's view, this disclosure provides useful information to users of financial statements about the lease payments that are excluded from lease liabilities as a consequence of the short-term lease exemption.

Leases of low-value assets

BC98 As noted in paragraph BC84, many lessees expressed concerns about the costs of applying the requirements of IFRS 16 to leases that are large in number but low in value. They suggested that such an exercise would require a significant amount of effort with potentially little effect on reported information.

BC99 In the light of these concerns, the IASB decided to provide a recognition exemption for leases of low-value assets. Consequently, IFRS 16 permits a lessee to elect, on a lease-by-lease basis, not to apply the recognition requirements of IFRS 16 to leases for which the underlying asset is of low value.

BC100 In developing the exemption, the IASB attempted to provide substantive relief to preparers while retaining the benefits of the requirements in IFRS 16 for users of financial statements. The IASB intended the exemption to apply to leases for which the underlying asset, when new, is of low value (such as leases of tablet and personal computers, small items of office furniture and telephones). 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. A lease will not qualify for the exemption if the nature of the underlying asset is such that, when new, its value is typically not low. The IASB also decided that the outcome of the assessment of whether an underlying asset is of low value should not be affected by the size, nature, or circumstances of the lessee—ie the exemption is based on the value, when new, of the asset being leased; it is not based on the size or nature of the entity that leases the asset.

BC101 The IASB conducted fieldwork to assess the effect that low-value asset leases would have if the right-of-use assets and lease liabilities were recognised in the financial statements of lessees. On the basis of this fieldwork, the IASB observed that, in most cases, assets and liabilities arising from leases within the scope of the exemption would not be material, even in aggregate. The IASB considered whether these findings demonstrated that the exemption would be of limited benefit to lessees because most leases that would be within its scope might instead be excluded from the recognition requirements of IFRS 16 by applying the concept of materiality in the *Conceptual Framework* and in IAS 1. However, in the light of feedback received from preparers of financial statements, the IASB concluded that the exemption would provide substantial cost relief to many lessees (and, in particular, smaller entities) by removing the burden of justifying that such leases would not be material in the aggregate.

BC102 The IASB acknowledged the risk that the aggregate value of leases captured by the exemption might be material in some cases. The IASB's fieldwork suggested that the aggregate value is most likely to be material for large assets made up of a number of individual leases of low-value assets (such as IT equipment made up of individually low-value component parts). Consequently, the IASB decided that if an underlying asset is highly dependent on, or highly interrelated with, other underlying assets, a lessee should not apply the recognition exemption to the lease of that individual asset. Similarly, the IASB decided that a lessee should not apply the recognition exemption to a lease of an underlying asset if the lessee cannot benefit from that underlying asset on its own or together with other readily available resources, irrespective of the value of that underlying asset.

BC103 The IASB decided that the recognition exemption for leases of low-value assets should be applied on a lease-by-lease basis. A requirement to apply the exemption by class of underlying asset, instead of lease-by-lease, would have introduced a burden on lessees to assess every individual asset within a class. Consequently, in the IASB's view, the recognition exemption for leases of low-value assets will be easier to apply, and of more benefit to lessees, if applied on a lease-by-lease basis.

BC104 The IASB also decided to require a lessee to disclose the amount of the expense recognised related to leases of low-value assets for which the lessee has elected to apply the recognition exemption (see paragraph 53(d) of IFRS 16 and paragraph BC217(c)). In the IASB's view, this disclosure provides useful information to users of financial statements about the amount of lease payments that are excluded from lease liabilities as a consequence of a lessee applying the exemption relating to leases of low-value assets.

Identifying a lease (paragraphs 9–17)

Definition of a lease (paragraphs 9–11)

BC105 IFRS 16 defines a lease on the basis of whether a customer controls the use of an identified asset for a period of time, which may be determined by a defined amount of use. If the customer controls the use of an identified asset for a period of time, then the contract contains a lease. This will be the case if the customer can make the important decisions about the use of the asset in a similar way to that in which it makes decisions about owned assets that it uses. In such cases, the customer (the lessee) has obtained the right to use an asset (the right-of-use asset) that it should recognise in its balance sheet (subject to the recognition exemptions in paragraph 5 of IFRS 16). In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service.

BC106 The 2010 Exposure Draft essentially retained the definition of a lease in IAS 17 and the accompanying requirements in IFRIC 4. Many respondents expressed concerns about the population of contracts that would be captured by the proposed requirements (and in particular that some contracts that they viewed as service contracts would be captured). Respondents also identified practice issues with IFRIC 4, such as difficulties in assessing the pricing structure of a contract, and questioned why the control criteria used in IFRIC 4 to define a lease were different from the control proposals that were then being developed within the context of revenue recognition and the control principle in IFRS 10 *Consolidated Financial Statements*.

BC107 Accordingly, in the 2013 Exposure Draft, the IASB proposed changes to the guidance on the definition of a lease to address those concerns. The 2013 Exposure Draft proposed using a control principle as the means of distinguishing between a service and a lease, and to align the principle with that in other Standards. Respondents generally supported these changes. However, many respondents stressed the increased importance of the definition of a lease, noting that the assessment of whether a contract contains a lease would generally determine whether a customer would recognise lease assets and lease liabilities. Some of these respondents thought that the IASB had not provided adequate guidance to support consistent application of the proposed definition to more complicated scenarios.

BC108 Accordingly, IFRS 16 generally retains the approach to the definition of a lease that was proposed in the 2013 Exposure Draft, but makes a number of changes to clarify the IASB's intentions and reduce the risk of inconsistent application.

BC109 The IASB is of the view that, in most cases, the assessment of whether a contract contains a lease should be straightforward. A contract will either fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgement. However, application guidance has been added to make it easier for entities to make the lease assessment for more complicated scenarios.

BC110 IFRS 16 requires an entity to assess whether a contract contains a lease at inception of the contract, rather than at commencement. This is because a lessor is required to classify a lease as either a finance lease or an operating lease at the inception date; this is consistent with the previous lessor lease classification requirements in IAS 17, which the IASB decided not to change. In addition, a lessee is required to disclose information about leases not yet commenced to which the lessee is committed if that information is relevant to users of financial statements.

Identified asset

BC111 The first requirement for a contract to meet the definition of a lease in IFRS 16 is that a customer should control the use of an identified asset. The requirement for an identified asset is substantially the same as the requirement in IFRIC 4 for the contract to depend on the use of a specified asset. It is important to know what the asset is in order to assess whether the customer has the right to control the use of that asset and, for example, to determine which asset finance lessors should derecognise. Nonetheless, when assessing at the inception date whether there is an identified asset, an entity does not need to be able to identify the particular asset (for example, a specific serial number) that will be used to fulfil the contract to conclude that there is an identified asset. Instead, the entity simply needs to know whether an identified asset is needed to fulfil the contract from commencement. If that is the case, then an asset is implicitly specified. IFRS 16 clarifies that an asset can be implicitly specified at the time that the asset is made available for use by the customer.

BC112 IFRS 16 includes requirements on asset substitution. If a supplier has a substantive right to substitute the asset throughout the period of use, then there is no identified asset and the contract does not contain a lease. This is because the supplier (and not the customer) controls the use of an asset if it can substitute the asset throughout the period of use.

BC113 The IASB has included application guidance to help determine the circumstances in which substitution rights are substantive. This guidance focuses on whether the supplier has the practical ability to substitute the asset and would benefit economically from doing so. The IASB's intention in including this guidance is to differentiate between:

(a) substitution rights that result in there being no identified asset because the supplier, rather than the customer, controls the use of an asset; and

(b) substitution rights that do not change the substance or character of the contract because it is not likely, or practically or economically feasible, for the supplier to exercise those rights.

If a substitution clause is not substantive because it does not change the substance of the contract, then that substitution clause should not affect an entity's assessment of whether a contract contains a lease. The IASB thinks that, in many cases, it will be clear that the supplier would not benefit from the exercise of a substitution right because of the costs associated with substituting an asset.

BC114 Substitution rights may not be substantive for a number of reasons. Some substitution rights are not substantive because the contract restricts when a supplier can substitute the asset. For example, if a contract states that a supplier can substitute the asset only on a specified future date or after the occurrence of a specified event, that substitution right is not substantive because it does not give the supplier the practical ability to substitute the asset throughout the period of use. Other substitution rights are not substantive even if the supplier contractually has the right to substitute the asset at any time. For example, if a supplier substitutes an asset for purposes of repair and maintenance, or if a supplier would benefit from substitution only in circumstances that are not considered likely to arise, those substitution rights are not substantive, regardless of whether those circumstances are specified in the contract.

BC115 Stakeholders raised concerns that in some cases it would be difficult, if not impossible, for a customer to determine whether a supplier's substitution right is substantive. Difficulties may arise because the customer often does not have information about the costs of substitution that would be incurred by the supplier. On the basis of this feedback, the IASB decided to state in IFRS 16 that, if a customer cannot readily determine whether a supplier has a substantive substitution right, then the customer should presume that any substitution right is not substantive. It is intended that a customer should assess whether substitution rights are substantive if it is reasonably able to do so—if substitution rights are substantive, then the IASB thinks that this would be relatively clear from the facts and circumstances. However, the requirement is also intended to clarify that a customer is not expected to exert undue effort in order to provide evidence that a substitution right is not substantive.

BC116 IFRS 16 also clarifies that an asset must be physically distinct to be an identified asset. The IASB concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (for example, if it is a 20 per cent capacity portion of a pipeline). The customer is unlikely to have the right to control the use of its portion because decisions about the use of the asset are typically made at the larger asset level. Widening the notion of an identified asset to possibly capture portions of a larger asset that are not physically distinct might have forced entities to consider whether they lease assets used to fulfil any contract for services, only to conclude that they do not. Consequently, the IASB concluded that widening the definition to include capacity portions of a larger asset would increase complexity for little benefit.

The right to control the use of an identified asset

BC117 IFRS 16 contains application guidance regarding what it means to have the right to control the use of an asset. The IASB decided that, to control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use (a 'benefits' element) but also the ability to direct the use of that asset (a 'power' element), ie a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from use of the asset throughout the period of use. Without any such decision-making rights, the customer would have no more control over the use of the asset than any customer purchasing supplies or services. If this were the case, the customer would not control the use of the asset. This guidance is consistent with the concept of control in IFRS 10 and IFRS 15, and with the IASB's proposals regarding control in the *Conceptual Framework* Exposure Draft. IFRS 10 and IFRS 15 define control to require both a 'benefits' element and a 'power' element.

Right to obtain substantially all of the economic benefits from use of the identified asset

BC118 IFRS 16 clarifies that only the economic benefits arising from use of an asset, rather than the economic benefits arising from ownership of that asset, should be considered when assessing whether a customer has the right to obtain the benefits from use of an asset. A lease does not convey ownership of an underlying asset; it conveys only the right to use that underlying asset. Accordingly, the IASB concluded that, when considering whether a contract contains a lease, a customer should not consider economic benefits relating to ownership of an asset (for example, tax benefits as a result of owning an asset). However, a customer should consider benefits relating to the use of the asset (for example, renewable energy credits received from the use of an asset or by-products resulting from the use of an asset).

Right to direct the use of the identified asset

BC119 IFRS 16 clarifies that a customer has the right to direct the use of an asset if it has the right to direct how and for what purpose the asset is used throughout the period of use (ie the right to make relevant decisions about how and for what purpose the asset is used throughout the period of use). If the supplier has that right, the supplier directs the use of the asset and, thus, no lease exists.

BC120 In the IASB's view, the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than other decisions to be made about use, including decisions about operating and maintaining the asset. This is because decisions about how and for what purpose an asset is used determine how, and what, economic benefits are derived from use. How and for what purpose an asset is used is a single concept, ie 'how' an asset is used is not assessed separately from 'for what purpose' an asset is used. Decisions regarding operating an asset are generally about implementing the decisions about how and for what purpose an asset is used and are dependent upon (and subordinate to) those decisions. For example, a supplier's operational decisions would have no effect on the economic benefits derived from use of an asset if the customer decides that the asset should not be used. In addition, if the supplier makes decisions about operating or maintaining an underlying asset, it often does so to protect its interest in that asset. The IASB observed that considering decisions about how and for what purpose an asset is used can be viewed as similar to considering the decisions made by a board of directors when assessing control of the entity. Decisions made by a board of directors about the operating and financing activities of an entity are generally the decisions that matter in that control assessment, rather than the actions of individuals in implementing those decisions.

BC121 The IASB noted that, in some cases, decisions about how and for what purpose an asset is used are predetermined and cannot be made by either the customer or the supplier during the period of use. This could happen if, for example, all decisions about how and for what purpose an asset is used are agreed between the customer and supplier in negotiating the contract and cannot be changed after the commencement date, or are, in effect, predetermined by the design of the asset. The IASB noted that it would expect decisions about how and for what purpose an asset is used to be predetermined in relatively few cases.

BC122 The approach to determining whether a customer has the right to direct the use of an identified asset changes if the decisions about how and for what purpose an asset is used are predetermined. IFRS 16 clarifies that, if decisions about how and for what purpose an asset is used are predetermined, a customer can still direct the use of an asset if it has the right to operate the asset, or if it designed the asset in a way that predetermines how and for what purpose the asset will be used. In either of these cases the customer controls rights of use that extend beyond the rights of a customer in a typical supply or service contract (ie the customer has rights that extend beyond solely ordering and receiving output from the asset). In these cases, the customer has the right to make (or has made in the case of design) decisions that affect the economic benefits to be derived from use of the asset throughout the period of use. Although the IASB thinks that each of these cases represents a scenario in which the customer directs the use of an asset, it expects that, for most leases, the assessment of whether a customer directs the use of an asset will be based on identifying the party that decides how and for what purpose an asset is used.

BC123 IFRS 16 also clarifies that only decisions made during the period of use (and not before the period of use) should be considered in the control assessment, unless the customer designed the asset in a way that predetermines how and for what purpose the asset will be used. In the IASB's view, if a customer specifies the output from an asset at or before the beginning of the period of use (for example, within the terms of the contract), and cannot change that specification during the period of use, it generally does not control the use of an asset. In that case, it would have no more decision-making rights than any customer in a typical supply or service contract.

BC124 In addition, IFRS 16 provides application guidance about protective rights—for example, terms and conditions included in the contract to protect the supplier's interest in the underlying asset or other assets, to protect its personnel or to ensure the supplier's compliance with applicable laws and regulations. In the IASB's view, such protective rights define the scope of the rights obtained by a customer without preventing a customer from having the right to direct the use of that asset. Accordingly, protective rights may affect the price paid for the lease (ie a lessee may pay less for the use of the asset if it is more restricted in its use of that asset). However, protective rights generally would not affect the existence of the customer's right to direct the use of the asset.

Other approaches considered for the definition of a lease

BC125 In developing IFRS 16, the IASB considered alternatives suggested by stakeholders regarding the definition of a lease. The main alternatives considered are described below:

(a) *Financing component*: the IASB considered requiring a lease to be a financing arrangement for the right to use an asset. In other words, there would have to be a clearly identifiable financing component for a contract to contain a lease. However, the IASB did not adopt this approach because:

(i) in the IASB's view, it is appropriate to focus on whether the customer has obtained control of a right-of-use asset to determine whether a contract contains a lease. The right-of-use asset gives rise to a corresponding lease liability if payments are made over time, but exists even if there is no lease liability (for example, when lease payments are fully prepaid). If an entity obtains the right to use an asset for a period of time, the contract contains a lease, regardless of the timing of payments for that right of use. The focus on the asset obtained in a lease also distinguishes leases from other contracts, such as service or supply arrangements.

(ii) many of the suggested indicators of 'financing arrangements' focus on the form of the payments, and on those payments being similar to payments within a loan agreement. The IASB was concerned that if it focused on the form of an arrangement, rather than its substance:

(A) many existing leases, including many existing finance leases and property leases, would no longer meet the definition of a lease, even when it is clear that the customer has obtained a right of use at contract commencement.

(B) it would be relatively easy to structure a contract to fail to meet the definition of a lease by, for example, changing the payment structure, while not changing the customer's right to use an asset.

(b) *IFRS 15*: the IASB considered whether to link the requirements on the definition of a lease more closely to the requirements in IFRS 15, in particular the requirements on whether a good or service is 'distinct'. Applying such an approach, the concept of 'distinct' could have been used to distinguish between contracts that contain distinct lease and service components (that an entity should unbundle and account for separately) and those that do not contain distinct lease and service components (and therefore would be accounted for entirely as a contract for services). The IASB did not adopt this approach because:

(i) the 'distinct' requirements in IFRS 15 were developed to address a different objective from that of identifying a lease. They were developed to identify the nature of an entity's promises in a contract with a customer to ensure the most appropriate allocation and recognition of revenue. In contrast, the lease definition requirements aim to identify whether a customer has obtained the right to use an asset and, therefore, should recognise the assets and liabilities associated with that transaction. Because the 'distinct' requirements in IFRS 15 were developed for a different purpose, applying those requirements might have resulted in customers failing to recognise items that meet the conceptual definition of assets and liabilities (see paragraphs BC22–BC27). The IASB thinks that control is a more appropriate basis on which to make this determination.

(ii) the IASB was concerned that a requirement to determine whether lease and service components were distinct would add unnecessary complexity to the guidance. This is because such an approach was expected to result in little difference in outcomes and yet would have included an additional requirement that could have been complicated to interpret and apply within the context of leases.

(c) *Stand-alone utility*: the IASB considered whether to specify that a customer controls the use of an asset only if that asset has stand-alone utility to the customer, ie only if the customer has the ability to derive the economic benefits from use of an asset, either on its own or together with other resources that could be sourced in a reasonable period of time. The IASB decided not to add this criterion because:

(i) the additional criterion is not necessary to appropriately determine if a customer controls the use of an asset. Such an approach is not used elsewhere in IFRS when assessing control of an asset, such as the purchase of an item of property, plant and equipment.

(ii) entities might reach different conclusions for contracts that contain the same rights of use, depending on differences in customers' resources or suppliers' business models.

(iii) assessing whether the criterion had been met would have been subjective and required judgement beyond that required to apply the definition of a lease in IFRS 16. It may also have had unintended consequences. In addition, the IASB did not identify any existing scenarios for which the inclusion of such a criterion would have been expected to change the lease conclusion. Consequently, the IASB concluded that the costs of including such a criterion would outweigh any possible benefits.

(d) *Substantial services*: the IASB considered whether to require an entity to account for a contract with lease and service components entirely as a service if the service components are substantial and are the predominant portion of the overall contract. The IASB decided not to include this requirement. Again, in the IASB's view, if a contract conveys to the customer the right to use an asset, the contract contains a lease. The presence of services, no matter how substantial, does not change the rights of use that a lessee obtains. The IASB was concerned that similar rights of use could be accounted for differently because services of a more significant value had been bundled together with some right-of-use assets and not with others.

Assessing whether a contract contains a lease when the customer is a joint arrangement

BC126 When two or more parties form a joint arrangement of which they have joint control as defined in IFRS 11 *Joint Arrangements*, those parties can decide to lease assets to be used in the joint arrangement's operations. The joint arrangement might be a joint venture or a joint operation. The contract might be signed by the joint arrangement itself if the joint arrangement has its own legal identity, or it might be signed by one or more of the parties to the joint arrangement on behalf of the joint arrangement. In these cases, the IASB decided to clarify that an entity should consider the joint arrangement to be the customer when assessing whether the contract contains a lease applying paragraphs 9–11 of IFRS 16—ie the parties to the joint arrangement should not each be considered to be a customer. Accordingly, if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use through their joint control of the arrangement, the contract contains a lease. In that scenario, it would be inappropriate to conclude that a contract does not contain a lease on the grounds that each of the parties to the joint arrangement either obtains only a portion of the economic benefits from use of the underlying asset or does not unilaterally direct the use of the underlying asset.

Cancellable leases

BC127 For the purposes of defining the scope of IFRS 16, the IASB decided that a contract would be considered to exist only when it creates rights and obligations that are enforceable. Any non-cancellable period or notice period in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. To be part of a contract, any options to extend or terminate the lease that are included in the lease term must also be enforceable; for example the lessee must be able to enforce its right to extend the lease beyond the non-cancellable period. If optional periods are not enforceable, for example, 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. Consequently, by definition, there is no contract beyond the non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. In assessing the enforceability of a contract, an entity should consider whether the lessor can refuse to agree to a request from the lessee to extend the lease.

BC128 Accordingly, if the lessee has the right to extend or terminate the lease, there are enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease would be required to consider those optional periods in their assessment of the lease term. In contrast, a lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease.

BC129 The IASB considered whether applying enforceability to leases in this way might encourage entities to add a clause to a lease that does not have economic substance, for example, stating that the lease could be cancelled at any point, knowing that, in practice, it would not be cancelled. However, the IASB is of the view that such clauses are unlikely to be added because there often is an economic disincentive for either the lessor or lessee to agree to their inclusion. For example, if a lessor has priced a contract assuming that the lessee will not cancel the contract, including such a clause would put the lessor at risk of being exposed to higher residual asset risk than had been anticipated when pricing the contract, which would be an economic disincentive for the lessor. Conversely, if the lessor has priced the contract assuming that the lessee will or may cancel the contract, the lessee would be likely to have to pay higher rentals to compensate the lessor for taking on more residual asset risk. Those higher rentals would be an economic disincentive for the lessee, if it does not intend to cancel the contract.

Combination of contracts (paragraph B2)

BC130 The IASB noted that, although it is usually appropriate to account for contracts individually, it is also necessary to assess the combined effect of contracts that are interdependent. An entity may enter into a number of contracts in contemplation of one another such that the transactions, in substance, form a single arrangement that achieves an overall commercial objective that cannot be understood without considering the contracts together. For example, assume that a lessee enters into a one-year lease of an asset with particular characteristics. The lessee also enters into a one-year lease for an asset with those same characteristics starting in one year's time and a similar forward contract starting in two years' time and in three years' time. The terms and conditions of all four contracts are negotiated in contemplation of each other such that the overall economic effect cannot be understood without reference to the series of transactions as a whole. In effect, the lessee has entered into a four-year lease. In such situations, accounting for the contracts independently of each other might not result in a faithful representation of the combined transaction.

BC131 The IASB noted that some view the concept of faithful representation in the *Conceptual Framework* as sufficient to identify the circumstances in which contracts should be combined. However, in the IASB's view, it is beneficial to add more clarity as to when to combine contracts within the context of leases, particularly with respect to sale and leaseback transactions, short-term leases and leases of low-value assets.

BC132 Consequently, the IASB decided to specify in IFRS 16 circumstances in which contracts should be combined and accounted for as a single contract. The requirements are similar to those in IFRS 15 and consistent with the concepts proposed in the *Conceptual Framework* Exposure Draft.

Separating components of a contract (paragraphs 12–17 and B32–B33)

BC133 Some contracts contain both lease and non-lease (service) components. For example, a contract for a car may combine a lease with maintenance services. In addition, many contracts contain two or more lease components. For example, a single contract may include leases of land, buildings and equipment.

Separating lease components

BC134 IFRS 16 contains requirements for determining whether a contract that contains a lease has only one lease component or a number of lease components. The IASB noted that the identification of separate lease components in a lease contract is similar to the identification of performance obligations in a revenue contract—in both circumstances, an entity is trying to identify whether a customer or a lessee is contracting for a number of separate deliverables or contracting for one deliverable that may incorporate a number of different assets. Accordingly, rather than developing new requirements addressing how to identify separate lease components, the IASB decided to include in IFRS 16 requirements similar to those in IFRS 15 on the identification of performance obligations. The IASB intends that those requirements in IFRS 16 are applied in a similar way to their application within the context of a revenue contract in IFRS 15.

Separating lease and non-lease components

BC135 The objective of the Leases project is to change the accounting for leases—not the accounting for services. The IASB, therefore, took the view that IFRS 16 should apply only to the lease components of any contract. The accounting for services (or the service components of a contract) should not be affected, regardless of whether the contract is only for services or includes the purchase, or lease, of an asset as well as services. Accordingly, IFRS 16 requires:

(a) a lessor to separate lease components and non-lease components of a contract. On the basis of feedback received from lessors, the IASB concluded that a lessor should be able to separate payments made for lease and non-lease components. This is because the lessor would need to have information about the value of each component, or a reasonable estimate of it, when pricing the contract.

(b) a lessee to separate lease components and non-lease components of a contract, unless it applies a practical expedient whereby it is not required to separate a lease component from any associated non-lease components and can instead elect to treat these as a single lease component. The IASB decided to permit this practical expedient for cost benefit reasons and in response to requests from preparers not to require separation in all scenarios. In the IASB's view, the practical expedient will reduce cost and complexity for some lessees, while not creating significant issues of comparability. This is because, in general, a lessee is not expected to adopt the practical expedient for contracts with significant service components because that would significantly increase the lessee's lease liabilities for those contracts. The IASB expects that lessees are likely to adopt this practical expedient only when the non-lease components of a contract are relatively small.

BC136 IFRS 16 requires a lessor to allocate the consideration in a contract to lease components and non-lease components applying the requirements in IFRS 15 on allocating the transaction price to performance obligations. This approach will ensure consistency for entities that are both a lessor and a seller of goods or services in the same contract. The IASB concluded that the approach applied by a lessor should not be different from the approach applied by a seller to allocate consideration in a revenue contract with more than one performance obligation.

BC137 If a lessee separates lease and non-lease components of a contract, IFRS 16 requires the lessee to allocate the consideration to those components on the basis of the relative stand-alone price of each lease component and the aggregate stand-alone price of the non-lease components. The IASB acknowledged that the stand-alone price of lease and non-lease components might not be readily available and, consequently, decided to permit the use of estimates, maximising the use of observable information. In the IASB's view, the use of estimated stand-alone prices by a lessee, if observable prices are not readily available, addresses some of the most significant concerns raised by both lessors and lessees with respect to the separation of lease and non-lease components: lessors had expressed concerns about providing pricing information to lessees and lessees had expressed concerns that obtaining observable stand-alone pricing information that is not readily available could be onerous and costly. The IASB also observed that applying the previous requirements in IAS 17, a lessee had been required to allocate the consideration in a contract between lease and non-lease components using estimates of the relative fair value of those components. The IASB was not aware of any significant practical difficulties in applying those requirements.

Distinguishing between a lease and a sale or purchase

BC138 The IASB considered whether to include requirements in IFRS 16 to distinguish a lease from the sale or purchase of an asset. The IFRS Interpretations Committee had received questions about whether particular contracts that do not transfer legal title of land should be considered to be a lease or a purchase of the land.

BC139 The IASB decided not to provide requirements in IFRS 16 to distinguish a lease from a sale or purchase of an asset. There was little support from stakeholders for including such requirements. In addition, the IASB observed that:

(a) the accounting for leases that are similar to the sale or purchase of the underlying asset would be similar to that for sales and purchases applying the respective requirements of IFRS 15 and IAS 16; and

(b) accounting for a transaction depends on the substance of that transaction and not its legal form. Consequently, if a contract grants rights that represent the in-substance purchase of an item of property, plant and equipment, those rights meet the definition of property, plant and equipment in IAS 16 and would be accounted for applying that Standard, regardless of whether legal title transfers. If the contract grants rights that do not represent the in-substance purchase of an item of property, plant and equipment but that meet the definition of a lease, the contract would be accounted for applying IFRS 16.

BC140 IFRS 16 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).

Recognition and the date of initial measurement: lessee (paragraphs 22–23 and 26)

Inception versus commencement of a lease

BC141 IFRS 16 requires a lessee to initially recognise and measure right-of-use assets and lease liabilities at the commencement date (ie the date on which the lessor makes the underlying asset available for use by the lessee).

BC142 Recognising assets and liabilities arising from a lease at the commencement date is consistent with the lessee accounting model, in which a lessee recognises an asset representing its right to use an underlying asset for the period of the lease and a liability representing its obligation to make lease payments. A lessee does not obtain and control its right to use the underlying asset until the commencement date. Before that date, the lessor has not yet performed under the contract. Although a lessee may have a right and an obligation to exchange lease payments for a right-of-use asset from the date of inception, the lessee is unlikely to have an obligation to make lease payments before the asset is made available for its use. The IASB noted that an obligation to exchange payments for a right-of-use asset could be onerous if the terms of the exchange are unfavourable. In such circumstances, a lessee could have an onerous contract liability before the commencement date. That liability would be accounted for consistently with other onerous contracts applying IAS 37.

BC143 The IASB noted that its intentions with respect to initial measurement of right-of-use assets and lease liabilities were that the measurement would reflect the nature of the transaction and the terms and conditions of the lease. That would require a lessee to look to the terms and conditions agreed to in the contract at the inception date (which could be before the commencement date). However, if the inception date was considered to be the date of initial measurement, that could result in a lessee recognising a gain or loss relating to changes between the dates of inception and commencement when recognising lease assets and lease liabilities at the commencement date. Therefore, the IASB decided to align the date of recognition with the date of initial measurement of right-of-use assets and lease liabilities.

BC144 The IASB noted that this approach has the following benefits:

(a) it clarifies that a gain or loss should not arise on initial recognition of right-of-use assets and lease liabilities by a lessee.

(b) it removes the need to add requirements (and thus potentially increase complexity) on how to account for changes to the terms and conditions of a lease, or assumptions used in measuring right-of-use assets and lease liabilities, between the inception date and the commencement date. Any changes to a lease that occur after the inception date and before the commencement date are taken into account when initially measuring the right-of-use asset and lease liability at the commencement date.

(c) it is more consistent with the measurement date for other transactions, such as the acquisition of property, plant and equipment.

Measurement: lessee (paragraphs 23–46)

Measurement bases of the right-of-use asset and the lease liability

BC145 The IASB decided to require a cost measurement basis for the right-of-use asset and lease liability, with cost measured by reference to the present value of the lease payments. The IASB concluded that this approach will provide useful information to users of financial statements. This is because it is consistent with the approach used to measure other similar assets and liabilities and thus is expected to result in more comparable information than other approaches. The IASB also concluded that using a cost measurement basis will be less costly for preparers than other approaches.

BC146 The IASB considered whether to refer to other Standards rather than specify in IFRS 16 the initial and subsequent measurement of the right-of-use asset and lease liability. The IASB did not adopt an approach that would refer to other Standards because:

(a) the approach would have been inconsistent with the IASB's decision not to apply a components approach to lease accounting (see paragraph BC153). For example, if a lessee were to account for all of the features of a lease applying other Standards, the requirements on financial instruments may have routinely required options in a lease to be accounted for separately.

(b) the approach could have been complex to apply, particularly when a lease contains relatively common features such as extension options, variable lease payments and residual value guarantees.

Initial measurement of the right-of-use asset (paragraphs 23–25)

BC147 The IASB decided that a lessee should measure the right-of-use asset at cost, defined as:

(a) the present value of the lease payments;

(b) any initial direct costs incurred by the lessee (see paragraphs BC149–BC151); and

(c) 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.

BC148 The IASB considered whether a lessee should initially measure the right-of-use asset at fair value, which may provide more relevant information about the economic benefits to be derived from use of the underlying asset. However, initial measurement of a right-of-use asset at cost is consistent with the measurement of many other non-financial assets, such as assets within the scope of IAS 16 and IAS 38. Measuring right-of-use assets on a basis similar to that used to measure the underlying asset maintains the comparability of amounts reported for leased and owned assets, which contributes to the usefulness of the information provided to users of financial statements. Furthermore, measuring the right-of-use asset at cost is less complex and less costly for entities than measuring that asset at fair value, because there often is not an active market for right-of-use assets. The IASB thinks that, for many leases, a cost measurement basis will also provide a reasonable approximation of the fair value of the right-of-use asset at the commencement date.

Initial direct costs (paragraph 24(c))

BC149 IFRS 16 requires a lessee to include initial direct costs in the initial measurement of the right-of-use asset and depreciate those costs over the lease term. Including initial direct costs in the measurement of the right-of-use asset is consistent with the treatment of costs associated with acquiring other non-financial assets (for example, property, plant and equipment and intangible assets).

BC150 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.

BC151 The IASB considered whether initial direct costs incurred by lessees should be allocated between the right-of-use asset and the lease liability at the commencement date. However, the IASB concluded that such an approach could be costly for entities to apply, with little incremental benefit for users of financial statements.

Initial measurement of the lease liability

Lease term: options to extend or terminate a lease (paragraphs 18–19)

BC152 Leases often grant the lessee a right to extend a lease beyond the non-cancellable period, or to terminate a lease before the end of the lease period. Depending on the terms and conditions of the option, a three-year lease with an option to extend for two years could be economically similar to a three-year non-cancellable lease or a five-year non-cancellable lease. However, a lease with options would never be exactly the same as a lease without any options.

BC153 There are a number of different ways that an entity could reflect duration-related options that exist in leases:

(a) *a components approach*, in which options in a lease are recognised and measured as separate components of the lease. The IASB did not adopt a components approach because it would have created a complex lease accounting model, would have been difficult to apply because options may be difficult to measure, and would have ignored the interrelationship between the term of a lease and the exercise of options.

(b) *a disclosure approach*, in which an entity recognises a lease liability or a lease receivable for the non-cancellable period and discloses the existence of any options to extend the term. Although simple to apply, the IASB did not adopt this approach because the measurement of lease assets and lease liabilities would ignore the existence of options, including those that are virtually certain to be exercised. Consequently, this approach would potentially misrepresent the assets and liabilities arising from a lease.

(c) *a measurement approach*, in which options in a lease are included in the measurement of lease assets and lease liabilities using a particular method. That method could be, for example:

  (i) a probability-weighted measurement method (in which the measurement of lease assets and lease liabilities reflects the probability of each possible lease term);

  (ii) a probability threshold method (in which an entity includes optional periods in the lease term if the exercise of the options meets a specified threshold, for example reasonably certain, virtually certain or more likely than not); or

  (iii) an economic incentive method (in which an entity includes optional periods in the lease term if an entity has an economic incentive to exercise the option).

BC154 Different views were expressed on whether optional periods should be included within an entity's determination of the lease term. Some stakeholders were of the view that payments to be made during future optional periods do not meet the definition of a liability for the lessee (or an asset for the lessor) until those options are exercised. This is because, before the exercise date, a lessee can avoid those payments by choosing to exercise a termination option or not to exercise an extension option. These stakeholders suggested limiting the lease term to the contractually committed period, ie the non-cancellable period. In addition, some stakeholders expressed concerns that including future optional periods within the lease term would not distinguish between, for example, a five-year non-cancellable lease and a three-year lease with an option to extend for two years. In their view, an entity with a five-year non-cancellable lease is in a different economic position from an entity with a three-year lease with an option to extend for two years that may or may not be exercised.

BC155 Conversely, many stakeholders thought that because options to extend or terminate leases affect the economics of those leases, there is a need to include some options when determining the lease term. If a lessee expects to exercise an option to extend the lease term, some think that including that longer lease term in the measurement of the right-of-use asset and lease liability would provide a more faithful representation of the economics of the lease. Inclusion of some renewal options is also needed to mitigate the risk of lessees inappropriately excluding lease liabilities from the balance sheet (for example, by excluding lease payments in optional periods for which the lessee has a clear economic incentive to exercise those options).

BC156 In the IASB's view, 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. Over the course of the Leases project, the IASB considered a number of ways of determining that reasonable expectation of what the term will be. These included:

(a) requiring an entity to determine the lease term as the longest possible term that is more likely than not to occur. Many stakeholders disagreed with this approach because, in their view, it would have been complex to apply to thousands of leases (which some entities have), and it would include payments in optional periods, which many stakeholders did not view as liabilities.

(b) requiring an entity to include in the lease term optional periods for which the lessee has a significant economic incentive to exercise an option. Under this approach, an expectation of exercise alone (and without any economic incentive to do so) would not be sufficient. The IASB noted that requiring an economic incentive provides a threshold that is more objective than a threshold based solely on management's estimates or intention, and consequently would help to address concerns that other approaches would be complex to apply. However, stakeholders were concerned about the costs of implementing any new concept regarding the lease term, particularly for entities with decentralised leasing operations and large volumes of leases with diverse individual lease term clauses. These stakeholders also asked whether a significant economic incentive threshold was similar to the 'reasonably certain' threshold that existed in IAS 17. They suggested that, if the IASB viewed the 'significant economic incentive' threshold as similar to the 'reasonably certain' threshold in IAS 17, the IASB should retain the terminology in IAS 17. They argued that the IAS 17 terminology was well understood, which would help to achieve consistent application between entities.

BC157 In the light of the feedback received, the IASB decided to retain the concept in IAS 17 that the lease term used to measure a lease liability should include optional periods to the extent that it is reasonably certain that the lessee will exercise its option to extend (or not to terminate) the lease. The IASB observed that applying the concept of 'reasonably certain' requires judgement and, therefore, also decided to provide application guidance in IFRS 16 to help entities to apply this concept. Accordingly, when initially determining the lease term, an entity should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise that option. The IASB decided to include guidance on the types of facts and circumstances that an entity should consider for two reasons:

(a) to help entities identify the relevant factors, which are not confined to the contractual payments during the optional periods. For example, within the context of property leases, the IASB noted the relevance of considering the costs of finding a new location at the end of the non-cancellable period and of relocating to that new location, or the importance of the location (for example, a head office or a flagship store) to the lessee.

(b) to reduce the risk of non-substantive break clauses being inserted within contracts solely to reduce the lease term beyond what is economically reasonable for the lessee.

BC158 The IASB observed that a lessee is sometimes obliged to choose between one or more options in a lease contract, each of which will result in an outflow of economic benefits for the lessee. In such cases, a lessee considers how the arrangement is most faithfully represented in the financial statements. For example, a lease contract might contain a set of options that results in:

(a) a choice for the lessee that represents an in-substance fixed payment. This might be the case, for example, if a lessee has the choice of either exercising an option to extend a lease or purchasing the underlying asset. The set of payments that aggregate to the lowest amount (on a discounted basis) from the available realistic options is the minimum amount that the lessee is obliged to pay. In the IASB's view, this minimum amount is an in-substance fixed payment that should be recognised as part of the cost of the right-of-use asset and as a liability by the lessee (see paragraph B42(c) of IFRS 16).

(b) a choice for the lessee that represents a guarantee provided to the lessor under which the lessee guarantees the lessor a minimum or fixed cash return regardless of whether an option is exercised. Such a situation might occur, for example, if an extension option is associated with a residual value guarantee or a termination penalty under which the lessor is guaranteed to receive an economic inflow at least equivalent to the payments that would be made by the lessee during the optional period. In the IASB's view, such an arrangement creates an economic incentive for the lessee to exercise the option to extend (or not to terminate) the lease (see paragraph B38 of IFRS 16).

BC159 Subsequent measurement of options to extend or terminate a lease is discussed in paragraphs BC184–BC187.

Discount rate (paragraph 26)

BC160 The IASB's objective in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced. With this in mind, the IASB decided that, if readily determinable by the lessee, a lessee should use the interest rate implicit in the lease.

BC161 The interest rate implicit in the lease is likely to be similar to the lessee's incremental borrowing rate in many cases. This is because both rates, as they have been defined in IFRS 16, take into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs. However, the interest rate implicit in the lease is generally also affected by a lessor's estimate of the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor, such as any initial direct costs of the lessor. Consequently, the IASB noted that it is likely to be difficult for lessees to determine the interest rate implicit in the lease for many leases, particularly those for which the underlying asset has a significant residual value at the end of the lease.

BC162 Accordingly, IFRS 16 requires a lessee to discount the lease liability using the interest rate implicit in the lease if that rate can be readily determined. If the interest rate implicit in the lease cannot be readily determined, then the lessee should use its incremental borrowing rate. In reaching this decision, the IASB decided to define the lessee's incremental borrowing rate to take into account the terms and conditions of the lease. The IASB noted that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point when determining its incremental borrowing rate for a lease (for example, the rate that a lessee has paid, or would pay, to borrow money to purchase the type of asset being leased, or the property yield when determining the discount rate to apply to property leases). Nonetheless, a lessee should adjust such observable rates as is needed to determine its incremental borrowing rate as defined in IFRS 16.

Lease payments

Variable lease payments (paragraph 27(a)–(b))

BC163 Some or all of the lease payments for the right to use an asset during the lease term can be variable. That variability arises if lease payments are linked to:

(a) price changes due to changes in a market rate or the value of an index. For example, lease payments might be adjusted for changes in a benchmark interest rate or a consumer price index.

(b) the lessee's performance derived from the underlying asset. For example, a lease of retail property may specify that lease payments are based on a specified percentage of sales made from that property.

(c) the use of the underlying asset. For example, a vehicle lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.

Variable lease payments that are in-substance fixed lease payments

BC164 In-substance fixed lease payments are payments that may, in form, contain variability but that in substance are unavoidable. IFRS 16 requires a lessee to include in-substance fixed lease payments in the measurement of lease liabilities because those payments are unavoidable and, thus, are economically indistinguishable from fixed lease payments. The IASB understands that this approach is similar to the way in which entities applied IAS 17, even though IAS 17 did not include explicit requirements in this respect. In response to requests from stakeholders, IFRS 16 also includes examples in the application guidance of the types of payments that are considered to be in-substance fixed payments to help in applying the requirement.

Variable lease payments that depend on an index or a rate

BC165 For similar reasons, the IASB decided to include variable lease payments that depend on an index or a rate in the measurement of lease liabilities. Those payments meet the definition of liabilities for the lessee because they are unavoidable and do not depend on any future activity of the lessee. Any uncertainty, therefore, relates to the measurement of the liability that arises from those payments and not to the existence of that liability.

BC166 In the IASB's view, forecasting techniques could be used to determine the expected effect of changes in an index or a rate on the measurement of lease liabilities. However, forecasting changes in an index or a rate requires macroeconomic information that may not be readily available to all entities, and may result in measurement uncertainty. The IASB noted that the usefulness of the enhanced information obtained using such a forecast often might not justify the costs of obtaining it, particularly for those lessees with a high volume of leases. The IASB considered requiring a lessee to use forward rates when measuring lease liabilities if those rates are readily available. However, it decided not to do so because this would reduce comparability between those using forward rates and those not doing so. Consequently, at initial recognition, IFRS 16 requires a lessee to measure payments that depend on an index or a rate using the index or rate at the commencement date (ie a lessee does not estimate future inflation but, instead, measures lease liabilities using lease payments that assume no inflation over the remainder of the lease term).

BC167 Subsequent measurement of variable lease payments that depend on an index or a rate is discussed in paragraphs BC188–BC190.

Variable lease payments linked to future performance or use of an underlying asset

BC168 There are differing views about whether variable payments linked to future performance or use of an underlying asset meet the definition of a liability. Some think that a lessee's liability to make variable lease payments does not exist until the future event requiring the payment occurs (for example, when the underlying asset is used, or a sale is made). Others think that a lessee's obligation to make variable lease payments exists at the commencement date by virtue of the lease contract and receipt of the right-of-use asset. Consequently, they think that all variable lease payments meet the definition of a liability for the lessee because it is the amount of the liability that is uncertain, rather than the existence of that liability.

BC169 The IASB decided to exclude variable lease payments linked to future performance or use of an underlying asset from the measurement of lease liabilities. For some Board members, this decision was made solely for cost-benefit reasons. Those Board members were of the view that all variable lease payments meet the definition of a liability for the lessee. However, they were persuaded by the feedback received from stakeholders that the costs of including variable lease payments linked to future performance or use would outweigh the benefits, particularly because of the concerns expressed about the high level of measurement uncertainty that would result from including them and the high volume of leases held by some lessees. Other Board members did not think that variable lease payments linked to future performance or use meet the definition of a liability for the lessee until the performance or use occurs. They regarded those payments to be avoidable by the lessee and, accordingly, concluded that the lessee does not have a present obligation to make those payments at the commencement date. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future economic benefits to be derived from use of the asset.

Residual value guarantees (paragraph 27(c))

BC170 The IASB decided that a lessee should account for a residual value guarantee that it provides to the lessor as part of the lease liability (and as part of the cost of the right-of-use asset). In reaching this decision, the IASB noted that payments resulting from a residual value guarantee cannot be avoided by the lessee—the lessee has an unconditional obligation to pay the lessor if the value of the underlying asset moves in a particular way. Accordingly, any uncertainty relating to the payment of a residual value guarantee does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary in response to movements in the value of the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee.

BC171 Therefore, the IASB decided that a lessee should estimate the amount expected to be payable to the lessor under residual value guarantees and include that amount in the measurement of the lease liability. In the IASB's view, the measurement of a residual value guarantee should reflect an entity's reasonable expectation of the amount that will be paid.

BC172 The IASB considered whether a lessee should recognise and measure residual value guarantees as separate components of a lease, because such guarantees are linked to the value of the underlying asset and may meet the definition of a derivative. However, the IASB noted that residual value guarantees are often interlinked with other terms and conditions in a lease so that accounting for the guarantees as separate components could diminish the relevance and faithful representation of the information provided. Recognising such guarantees separately could also be costly to apply.

Options to purchase the underlying asset (paragraph 27(d))

BC173 The IASB decided that purchase options should be included in the measurement of the lease liability in the same way as options to extend the term of a lease (ie the exercise price of a purchase option would be included in the measurement of a lease liability if the lessee is reasonably certain to exercise that option). This is because the IASB views a purchase option as effectively the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the IASB concluded that, for the same reasons underlying the decision to include extension options, including the exercise price within the measurement of a lease liability if the lessee is reasonably certain to exercise the option provides the most useful information to users of financial statements.

Subsequent measurement of the right-of-use asset (paragraphs 29–35)

BC174 The IASB decided that, after the commencement date, a lessee should measure the right-of-use asset at cost less accumulated depreciation and accumulated impairment losses, adjusted for remeasurements of the lease liability (see paragraph BC192). Paragraphs BC41–BC56 include a detailed discussion of the feedback received on the lessee accounting model and the basis for the IASB's decisions regarding the subsequent measurement of a lessee's right-of-use asset.

BC175 The IASB did not adopt an alternative approach whereby a lessee would be required to measure the right-of-use asset at fair value after initial measurement, because this approach would be:

(a) inconsistent with the subsequent measurement of many other non-financial assets; and

(b) more complex and costly for entities to apply than a cost-based approach, because it requires the use of both current expected cash flows and current interest rates.

Impairment of the right-of-use asset (paragraph 33)

BC176 The IASB decided that a lessee should apply the impairment requirements of IAS 36 to the right-of-use asset. In the IASB's view, this requirement enables users of financial statements to better compare assets that a lessee owns with those that it leases. In addition, it could be difficult for a lessee to implement an impairment model for right-of-use assets that is different from the model applied to other non-financial assets, particularly if a lessee is required to assess a group of assets (comprising both leased and owned assets) for impairment together.

Other measurement models for the right-of-use asset (paragraphs 34–35)

BC177 IFRS permits the revaluation of non-financial assets, such as property, plant and equipment. Accordingly, the IASB saw no reason not to allow a lessee to revalue right-of-use assets, albeit only if the lessee revalues similar classes of owned assets.

BC178 IFRS also permits investment properties to be measured at fair value. IAS 40 requires an entity to measure all investment property using the same measurement basis (either the cost model or the fair value model). This is because measuring all investment property on the same basis provides more useful information than allowing an entity to choose the measurement basis for each property. IFRS 16 has amended the scope of IAS 40 by defining investment property to include both owned investment property and investment property held by a lessee as a right-of-use asset. This results in lessees using either the cost model and disclosing fair value, or using the fair value model, depending on whether the lessee accounts for the remainder of its investment property under the cost model or the fair value model. In the IASB's view, this approach will provide useful information to users of financial statements about the fair value of investment property held by a lessee as a right-of-use asset, which is consistent with information provided about owned investment property.

BC179 Some stakeholders expressed concerns about the costs of determining the fair value of right-of-use assets (whether for disclosure or measurement purposes). The IASB acknowledged that there might be costs involved with determining the fair value of right-of-use assets, particularly for entities that are not in the property industry but sublease property, for example, because that property is not needed for use within their business. However, the IASB noted that there are two factors that will lessen the likelihood that entities that are not in the property industry will hold investment property as a right-of-use asset:

(a) IFRS 16 requires an entity to classify a sublease by reference to the right-of-use asset arising from the head lease (see paragraphs BC233–BC234). Consequently, an intermediate lessor would classify a sublease as a finance lease if it subleases the asset for all or most of the remaining term of the head lease. In those cases, the intermediate lessor would apply finance lease accounting (ie recognise a net investment in the sublease rather than the underlying right-of-use asset) and, thus, would not be required to apply the requirements of IAS 40. The IASB observed that entities that are not in the property industry that wish to reduce property costs would generally aim to secure a sublease for the entire remaining period of the head lease, which (if successful) would result in finance lease accounting.

(b) entities that are not in the property industry may not be within the scope of IAS 40 if they sublease a property under an operating lease with the intention of subsequently using the property within their own business. Such a property would not meet the definition of an investment property in IAS 40 because it would not be held solely for rentals, capital appreciation or both.

BC180 In the IASB's view it should be relatively straightforward to determine the fair value of right-of-use assets if the sublease does not contain any options or variable lease payments. Determining the fair value would involve projecting the cash flows that the entity expects to receive from subleasing the asset. The IASB concluded that, for an entity that is not in the property industry, determining these cash flows would normally be relatively straightforward because it is likely that a sublease would already be in place.

BC181 Some stakeholders asked that IAS 40 provide additional requirements on measuring the fair value of right-of-use assets if leases have variable and optional payments, or if there is no active market for the right-of-use asset. In the IASB's view, the principles in IFRS 13 *Fair Value Measurement* and IAS 40 are sufficient to help lessees to measure the fair value of those right-of-use assets. In particular, the IASB noted that paragraph 50(d) of IAS 40 explains when to include in the measurement of the right-of-use asset options and variable lease payments that are not included in the measurement of the lease liability.

Subsequent measurement of the lease liability (paragraphs 20–21 and 36–43)

BC182 The IASB decided that a lessee should measure lease liabilities similarly to other financial liabilities using an effective interest method, so that the carrying amount of the lease liability is measured on an amortised cost basis and the interest expense is allocated over the lease term.

BC183 IFRS 16 does not require or permit a lessee to measure lease liabilities at fair value after initial measurement. In the IASB's view, this approach would have been:

(a) inconsistent with the subsequent measurement of many other non-derivative financial liabilities, thus decreasing comparability for users of financial statements; and

(b) more complex and costly for entities to apply than a cost-based approach, because it requires the use of both current expected cash flows and current interest rates.

Reassessment of options (paragraph 20)

BC184 In principle, the IASB is of the view that users of financial statements receive more relevant information if lessees reassess extension, termination and purchase options on a regular basis. The resulting information is more relevant because reassessment reflects current economic conditions, and using a lease term established at the commencement date throughout the lease could be misleading.

BC185 However, requiring reassessment at each reporting date would be costly for an entity with many leases that include options. The IASB considered ways in which IFRS 16 could address that concern while still providing useful information to users of financial statements. It decided that an appropriate balance would be achieved by:

(a) requiring reassessment only upon the occurrence of a significant event or a significant change in circumstances that affects whether the lessee is reasonably certain to exercise, or not to exercise, an option to extend a lease, to terminate a lease or to purchase an underlying asset. The IASB noted that this requirement is similar in some respects to the approach taken for the impairment of long-lived assets (other than goodwill and indefinite-lived intangible assets) in IAS 36. IAS 36 does not require impairment testing at each reporting date. Instead, an entity tests for impairment when there has been an indication that the asset may be impaired.

(b) requiring reassessment only if the significant event or significant change in circumstances is within the control of the lessee. Limiting the reassessment requirement in this way means that a lessee is not required to reassess options in response to purely market-based events or changes in circumstances.

BC186 The IASB noted that an entity will need to apply judgement in identifying significant events or significant changes in circumstances that trigger reassessment and that it would be impossible to provide a list of all possible triggering events. Nonetheless, the IASB decided to provide some examples of possible triggering events to help entities apply that judgement.

BC187 The IASB considered but did not adopt the following approaches:

(a) *requiring a lessee to reassess options when there has been a change in facts or circumstances that would indicate that there is a significant change in the right-of-use asset or lease liability*. Many stakeholders thought that it could be difficult to interpret when a change in the right-of-use asset or lease liability is significant. In addition, stakeholders were concerned about both the costs of performing reassessment and, if relevant, the costs associated with demonstrating that reassessment was not required, which might be as costly as reassessing options at each reporting date.

(b) *requiring a lessee to reassess options when the lessee has, or no longer has, a significant economic incentive that would make exercise of an option reasonably certain*. Many stakeholders thought that the cost of applying this approach would exceed any benefit, because an entity might incur significant costs in continuously assessing and monitoring relevant factors that give rise to a significant economic incentive even though the lease term conclusion might not change.

Reassessment of variable lease payments that depend on an index or a rate (paragraph 42(b))

BC188 In principle the IASB is of the view that users of financial statements receive more relevant information about a lessee's lease liabilities if the lessee updates the measurement of its liabilities to reflect a change in an index or a rate used to determine lease payments (including, for example, a change to reflect changes in market rental rates following a market rent review). For example, without such remeasurement, the measurement of the lease liability for a 20-year property lease, for which lease payments are linked to an inflation index, is unlikely to provide users of financial statements with useful information about the entity's future cash outflows relating to that lease throughout the lease term.

BC189 Some stakeholders expressed concerns about the cost of performing reassessments each time a rate or an index changes, and questioned whether the benefits for users of financial statements would outweigh the costs for lessees. For example, some stakeholders noted that the total expenses related to leases recognised in profit or loss by a lessee would be substantially the same, regardless of whether the lessee remeasures the lease liability for changes in an index or a rate.

BC190 In the light of this feedback, the IASB decided that a lessee should reassess variable lease payments that are determined by reference to an index or a rate only when there is a change in the cash flows resulting from a change in the reference index or rate (ie when the adjustment to the lease payments takes effect). The IASB noted that this approach is less complex and costly to apply than requiring a lessee to reassess variable lease payments at each reporting date. This is because a lessee would typically be expected to report its financial results more frequently than the occurrence of a contractual change in the cash flows of a lease with payments that depend on an index or a rate.

Reassessment of residual value guarantees (paragraph 42(a))

BC191 The IASB decided that lessees should reassess the amounts expected to be payable under residual value guarantees, because that provides more relevant information to users of financial statements, by reflecting current economic conditions.

Accounting for the effects of reassessing lease payments (paragraph 39)

BC192 The IASB decided that, if a lessee remeasures its lease liability to reflect changes in future lease payments, the lessee should recognise the amount of the remeasurement as an adjustment to the cost of the right-of-use asset. The IASB considered whether some changes to the measurement of the lease liability should be recognised in profit or loss because, for example, the reassessment of an option or a change in an index or a rate could be viewed as an event relating to the current period. However, the IASB decided that a lessee should recognise the remeasurement as an adjustment to the right-of-use assets for the following reasons:

(a) a change in the assessment of extension, termination or purchase options reflects the lessee's determination that it has acquired more or less of the right to use the underlying asset. Consequently, that change is appropriately reflected as an adjustment to the cost of the right-of-use asset.

(b) a change in the estimate of the future lease payments is a revision to the initial estimate of the cost of the right-of-use asset, which should be accounted for in the same manner as the initial estimated cost.

(c) the requirement to update the cost of the right-of-use asset is similar to the requirements in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. IFRIC 1 requires an entity to adjust the cost of the related asset for a change in the estimated timing or amount of the outflow of resources associated with a change in the measurement of an existing decommissioning, restoration or similar liability.

Reassessment of the discount rate (paragraphs 41 and 43)

BC193 The IASB decided that, in most cases, an entity should not reassess the discount rate during the lease term. This approach is generally consistent with the approach applied to financial instruments accounted for using the effective interest method. The IASB noted that in other Standards in which the discount rate is required to be reassessed, it is typically because the liability to which the discount rate relates is measured on a current value measurement basis.

BC194 Nonetheless, in the IASB's view, there are some circumstances in which an entity should reassess the discount rate. Consequently, IFRS 16 requires a lessee to remeasure the lease liability using revised payments and a revised discount rate when there is a change in the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset. In the IASB's view, in those circumstances, the economics of the lease have changed and it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of the lease liability (and right-of-use asset).

BC195 The IASB also decided that, in a floating interest rate lease, a lessee should use a revised discount rate to remeasure the lease liability when there is a change in lease payments resulting from changes in the floating interest rate. This approach is consistent with the requirements in IFRS 9 for the measurement of floating-rate financial liabilities subsequently measured at amortised cost.

Foreign currency exchange

BC196 IFRS 16 does not provide specific requirements on how a lessee should account for the effects of foreign currency exchange differences relating to lease liabilities that are denominated in a foreign currency. Consistently with other financial liabilities, a lessee's lease liability is a monetary item and consequently, if denominated in a foreign currency, is required to be remeasured using closing exchange rates at the end of each reporting period applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

BC197 Some stakeholders suggested that a lessee should recognise any foreign currency exchange differences as an adjustment to the carrying amount of the right-of-use asset. This approach would treat translation adjustments as an update to the cost of the right-of-use asset, which is initially measured on the basis of the initial measurement of the lease liability. These stakeholders are of the view that lease payments denominated in a foreign currency are in effect another form of variable lease payment, and should be accounted for similarly to variable lease payments that depend on an index or a rate. These stakeholders also questioned whether useful information will be obscured as a result of the profit or loss volatility that might arise as a result of recognising foreign currency exchange differences on a lessee's lease liability in profit or loss.

BC198 The IASB decided that any foreign currency exchange differences relating to lease liabilities denominated in a foreign currency should be recognised in profit or loss, for the following reasons:

(a) this approach is consistent with the requirements for foreign exchange differences arising from other financial liabilities (for example, loans and previous finance lease liabilities accounted for applying IAS 17).

(b) a lessee with a liability denominated in a foreign currency is exposed to foreign currency risk. Consequently, foreign currency exchange gains or losses recognised in profit or loss faithfully represent the economic effect of the lessee's currency exposure to the foreign exchange risk.

(c) if a lessee enters into derivatives to hedge its economic exposure to foreign currency risk, the recognition of foreign currency exchange differences relating to lease liabilities as an adjustment to the cost of right-of-use assets would prevent a natural offset of the economic exposure in profit or loss. This is because an entity would recognise any change in the foreign currency risk for the derivatives in profit or loss, whereas it would recognise the corresponding change in lease liabilities in the balance sheet—thus introducing volatility as a result of reducing exposure to foreign currency risk. This mismatch could distort the reported economic position of the lessee.

(d) in the IASB's view, subsequent changes to a foreign exchange rate should not have any effect on the cost of a non-monetary item. Consequently, it would be inappropriate to include such changes in the remeasurement of the right-of-use asset.

BC199 Although this approach could result in volatility in profit or loss from the recognition of foreign currency exchange differences, an entity would disclose those changes separately as foreign currency exchange gains or losses. Accordingly, it would be clear to users of financial statements that the gain or loss results solely from movements in foreign exchange rates. Because this approach is consistent with the requirements for foreign currency exchange differences in IAS 21, the IASB concluded that it was not necessary to include any specific requirements in IFRS 16.

Lease modifications (paragraphs 44–46)

BC200 IAS 17 did not address the accounting for lease modifications. The IASB decided that it would be useful to include a general framework for accounting for lease modifications in IFRS 16 because modifications occur frequently for many types of leases.

BC201 The IASB decided to define a lease modification as a change in the scope of a lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term), or the consideration for a lease, that was not part of the original terms and conditions of the lease. In defining lease modifications, the IASB differentiated between scenarios resulting in the remeasurement of existing lease assets and lease liabilities that are not lease modifications (for example, a change in lease term resulting from the exercise of an option to extend the lease when that option was not included in the original lease term) and those resulting in a lease modification (for example, a change in the lease term resulting from changes to the terms and conditions of the original lease).

BC202 The IASB decided that an entity should further distinguish between those lease modifications that, in substance, represent the creation of a new lease that is separate from the original lease and those that, in substance, represent a change in the scope of, or the consideration paid for, the existing lease. Consequently, IFRS 16 requires a lessee to account for a lease modification as a separate lease if the modification increases the scope of the lease by adding the right to use one or more underlying assets and the consideration paid for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

BC203 For those lease modifications that do not result in a separate lease, the IASB decided that a lessee should remeasure the existing lease liability using a discount rate determined at the effective date of the modification. The IASB decided that:

(a) for lease modifications that decrease the scope of a lease, a lessee should decrease the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease and recognise a corresponding gain or loss. In the IASB's view, this gain or loss appropriately reflects the economic effect of the partial or full termination of the existing lease resulting from the decrease in scope.

(b) for all other lease modifications, a lessee should make a corresponding adjustment to the carrying amount of the right-of-use asset. In these cases, the original lease is not terminated because there is no decrease in scope. The lessee continues to have the right to use the underlying asset identified in the original lease. For lease modifications that increase the scope of a lease, the adjustment to the carrying amount of the right-of-use asset effectively represents the cost of the additional right of use acquired as a result of the modification. For lease modifications that change the consideration paid for a lease, the adjustment to the carrying amount of the right-of-use asset effectively represents a change in the cost of the right-of-use asset as a result of the modification. The use of a revised discount rate in remeasuring the lease liability reflects that, in modifying the lease, there is a change in the interest rate implicit in the lease (which the discount rate is intended to approximate).

BC204 The IASB concluded that this approach results in accounting outcomes that faithfully represent the substance of a lease modification and will closely align gain or loss recognition with a corresponding change in the lessee's rights and obligations under the lease. This is because a lease gives rise to both a right-of-use asset and a lease liability. Accordingly, a lease modification can result in a change to the lessee's rights (ie a change to the right-of-use asset), a change to the lease liability, or both.

BC205 The IASB considered requiring a lessee to distinguish between changes to a lease that are substantial and those that are not substantial, in a manner similar to that required for contract modifications relating to financial liabilities within the scope of IFRS 9. This approach would require a lessee to account for the lease modification as (a) a new lease, when the change represents a substantial modification; or (b) a continuation of the original lease, when the change does not represent a substantial modification. However, the IASB did not adopt this approach because, as a result of the link to the right-of-use asset, it could result in outcomes that would not faithfully represent the differing nature of each of those changes. For example, there are scenarios in which this approach would result in the extinguishment of the original lease (and the recognition of a corresponding gain or loss in profit or loss) when the lessee continues to have all of the rights it had in the original lease after the modification.

Presentation: lessee (paragraphs 47–50)

Statement of financial position (paragraph 47–48)

BC206 The IASB decided that, if not presented separately in the balance sheet, right-of-use assets should be included within the same line item as similar owned assets. The IASB concluded that, if right-of-use assets are not presented as a line item, presenting similar leased and owned assets together would provide more useful information to users of financial statements than other approaches. This is because a lessee often uses owned assets and leased assets for the same purpose and derives similar economic benefits from the use of owned assets and leased assets.

BC207 However, the IASB noted that there are differences between a right-of-use asset and an owned asset, and that users of financial statements may want to know the carrying amount of each separately. For example, right-of-use assets may be viewed as being (a) less risky than owned assets, because a right-of-use asset may not embed residual asset risk; or (b) more risky than owned assets, because the lessee may need to replace the right-of-use asset at the end of the lease term, but may not be able to secure a similar rate for the replacement lease. Accordingly, IFRS 16 requires a lessee to provide information about the carrying amount of right-of-use assets separately from assets that are owned, either in the balance sheet or in the notes.

BC208 Similarly, the IASB decided that a lessee should present lease liabilities separately from other liabilities, either in the balance sheet or in the notes. In reaching this decision, the IASB noted that leasing is an important activity for many lessees. Although a lease liability shares many common characteristics with other financial liabilities, a lease liability is contractually related to a corresponding asset and often has features, such as options and variable lease payments, that differ from those typically found in other liabilities. Thus, presenting lease liabilities separately from other financial liabilities (along with the disclosure requirements discussed in paragraphs BC212–BC230) provides users of financial statements with information that is useful in understanding an entity's obligations arising from lease arrangements. The IASB also noted that paragraph 55 of IAS 1 requires a lessee to further disaggregate line items in the balance sheet if such presentation is relevant to an understanding of the lessee's financial position.

Statement of profit or loss and other comprehensive income (paragraph 49)

BC209 The IASB decided that a lessee should present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset in the income statement. The IASB concluded that a lessee would provide more useful information to users of financial statements by presenting interest on the lease liability together with interest on other financial liabilities and depreciation of the right-of-use asset together with other similar expenses (for example, depreciation of property, plant and equipment). Paragraphs BC41–BC56 include a discussion of the basis for the IASB's decisions relating to amounts recognised in profit or loss by a lessee.

Statement of cash flows (paragraph 50)

BC210 The IASB's decisions on the presentation of lease cash outflows are linked to the nature of the right-of-use asset and lease liability, and the presentation of expenses arising from a lease in the income statement. In the IASB's view, it would be misleading to portray payments in one manner in the income statement and in another in the statement of cash flows.

BC211 Consequently, the IASB decided that a lessee should classify the principal portion of cash repayments of the lease liability as financing activities in the statement of cash flows and classify cash payments relating to interest consistently with other interest payments. This approach is consistent with the requirements in IAS 7 *Statement of Cash Flows* for cash flows relating to financial liabilities and provides comparability between interest paid on leases and interest paid on other financial liabilities. This approach also results in a lessee accounting for a lease consistently in the balance sheet, income statement and statement of cash flows. For example, a lessee (a) measures and presents the lease liability similarly to other financial liabilities; (b) recognises and presents interest relating to that liability in a similar manner to interest on other financial liabilities; and (c) presents cash paid relating to interest on lease liabilities similarly to interest on other financial liabilities.

Disclosure: lessee (paragraphs 51–60)

BC212 In determining the disclosures for leases, the IASB considered the following:

(a) the disclosure requirements of IAS 17;

(b) the disclosure requirements for financial liabilities in IFRS 7 *Financial Instruments: Disclosures*;

(c) the disclosure requirements for non-current assets such as property, plant and equipment;

(d) work on other related projects such as the Disclosure Initiative (a broad-based initiative to explore how disclosures in IFRS financial reporting can be improved); and

(e) feedback received on the disclosure proposals in the 2010 and 2013 Exposure Drafts.

BC213 The IASB received significant feedback regarding lessee disclosures. In particular:

(a) many lessees had significant concerns about the costs of complying with the disclosures proposed in the 2010 and 2013 Exposure Drafts. This was a particular concern for lessees with a high volume of leases with unique terms and conditions. These lessees suggested that there should be no need to expand the disclosure requirements beyond those in IAS 17 if the lessee accounting model in IFRS 16 provides the information that investors need. These lessees also argued that the proposed lessee disclosure requirements did not seem to be consistent with the IASB's efforts to address 'disclosure overload' in other projects (ie increases in the volume of disclosures and a perceived reduction in the quality and usefulness of those disclosures).

(b) in contrast, many users of financial statements thought that the detailed disclosure requirements proposed in the 2010 and 2013 Exposure Drafts would provide useful information. Over the course of the project, the IASB held meetings with investors and analysts to discuss how particular disclosures would be used in their analysis and which disclosures would be the most useful.

(c) both preparers and users of financial statements had concerns that lengthy detailed disclosure requirements could lead to the use of 'boilerplate' statements rather than the provision of useful information. These stakeholders were particularly concerned about the risk of material information being 'lost' within lengthy and complex financial statement notes. Similarly, many stakeholders suggested that IFRS 16 should explicitly state that entities should apply materiality in determining the extent to which disclosures are required.

(d) some users of financial statements noted that the most useful information would be different for different lease portfolios. These users noted that, for leases with complex terms and conditions (which, for some entities, are the leases in which users are most interested), compliance with standardised disclosure requirements often does not meet their information needs.

BC214 In response to this feedback, the IASB decided to:

(a) include an overall disclosure objective in IFRS 16 (paragraphs BC215–BC216);

(b) require a lessee to disclose quantitative information about its right-of-use assets, and expenses and cash flows related to leases (paragraphs BC217–BC223); and

(c) require a lessee to disclose any additional information that is necessary to satisfy the overall disclosure objective, and to supplement this requirement with a list of user information needs that any additional disclosures should address (paragraphs BC224–BC227).

Overall disclosure objective (paragraph 51)

BC215 Consistently with other recently issued Standards, the IASB decided that IFRS 16 should specify an overall objective for lessee disclosures. In the IASB's view, a clear objective should improve the interpretation and implementation of the disclosure requirements. This is because a lessee is required to assess whether the overall quality and informational value of its lease disclosures are sufficient to meet the stated objective.

BC216 The IASB considered stakeholder suggestions that an explicit statement about materiality would be useful in applying the lessee disclosure requirements. However, such statements are not included in other Standards. The concept of materiality in the *Conceptual Framework* and in IAS 1 is pervasive across IFRS and applies to the requirements in IFRS 16 in the same way that it applies to the requirements in all other Standards. The IASB thought that including a statement about materiality within the disclosure requirements in IFRS 16 might be interpreted as implying that materiality does not apply to the disclosure requirements in other Standards, because materiality is not explicitly mentioned in those Standards. The IASB is of the view that implicit in the overall disclosure objective is the notion that the level of detail provided in disclosures should reflect the significance of a lessee's leasing activities to its financial statements. The IASB concluded that guidance on applying the overall disclosure objective would be helpful to lessees but noted that such guidance is already provided in paragraphs 30A and 31 of IAS 1.

Disclosures about right-of-use assets, and expenses and cash flows related to leases (paragraph 53)

BC217 The IASB decided that there are particular items of information that, if material, should be disclosed by lessees to meet the information needs of users of financial statements. The IASB noted the importance of comparable information being provided by different lessees and that comparability could be achieved by including some specific disclosure requirements in IFRS 16. These disclosure requirements relate to the information that users of financial statements have identified as being most useful to their analyses and, consequently, that they would like to have for all lease portfolios that are material to an entity. Consequently, IFRS 16 requires a lessee to disclose:

(a) the carrying amount of right-of-use assets, and depreciation charge for those assets, split by class of underlying asset. This information is useful in understanding the nature of a lessee's leasing activities and in comparing entities that lease their assets with those that purchase them.

(b) interest expense on lease liabilities. Together with the disclosure of the carrying amount of lease liabilities separately from other liabilities (see paragraph BC208), this disclosure provides information about a lessee's lease obligations and finance costs.

(c) the expenses related to short-term leases and leases of low-value assets accounted for applying paragraph 6 of IFRS 16, and the expense related to variable lease payments not included in the measurement of lease liabilities. These disclosures provide information about lease payments for which assets and liabilities are not recognised in the balance sheet.

(d) total cash outflow for leases. This disclosure was identified by users of financial statements as providing the most useful information about lease cash flows and is expected to help in forecasting future lease payments.

(e) additions to right-of-use assets. This disclosure provides comparable information about capital expenditure on leased and owned assets.

(f) gains and losses arising from sale and leaseback transactions. This disclosure helps to better understand the unique characteristics of sale and leaseback transactions and the effect that such transactions have on a lessee's financial performance.

(g) income from subleasing right-of-use assets. This disclosure is useful because, along with the information about expenses related to leases discussed above, it provides a complete depiction of the overall income statement effect of an entity's leasing activities.

Maturity analysis (paragraph 58)

BC218 IFRS 16 requires a lessee to disclose a maturity analysis for lease liabilities applying paragraphs 39 and B11 of IFRS 7.

BC219 Users of financial statements identified the main objective of a maturity analysis as being to help them understand liquidity risk and estimate future cash flows. The IASB's view is that the requirements of IFRS 7 achieve this objective, and also provide a lessee with the flexibility to present the maturity analysis that is most relevant to its particular lease portfolio.

BC220 The IASB considered whether IFRS 16 should instead include more prescriptive requirements for a maturity analysis similar to that required by IAS 17 (for example, by requiring a lessee to disclose undiscounted lease payments in each of the first five years and a total for the periods thereafter). Feedback from users of financial statements relating to the maturity analysis requirements of IAS 17 was generally positive. In particular, the prescriptive nature of the requirement ensured that different lessees provided information that was comparable.

BC221 Applying IFRS 7 to lease liabilities requires lessees to apply judgement in selecting time bands for the maturity analysis. The IASB thinks that, in a scenario in which disclosing undiscounted cash flows for each of the first five years and a total for the periods thereafter provides the most useful information to users of financial statements, the requirements of IFRS 7 should lead a lessee to disclose this level of detail. In contrast, in a scenario in which an alternative (and possibly more detailed) set of time bands provides the most useful information to users of financial statements, the requirements of IFRS 7 should lead a lessee to disclose that alternative and more useful set of time bands. For example, for a portfolio of 15–20 year leases, the requirements of IFRS 7 should lead a lessee to provide a more detailed maturity analysis than a single amount for the years beyond the fifth year.

BC222 In addition, the IASB is of the view that it is appropriate to apply the same maturity analysis disclosure requirements to lease liabilities as those applied to other financial liabilities. This is because the lessee accounting model in IFRS 16 is based on the premise that a lease liability is a financial liability (for the reasons described in paragraphs BC46–BC51).

BC223 The IASB decided not to require the disclosure of a maturity analysis of non-lease components. The IASB thinks that users of financial statements would find information about the maturities of any contractual commitments of an entity useful, regardless of the nature of the entity's rights under the contract. However, the IASB noted that it could be misleading to require the disclosure of contractual commitments for services that are embedded within a lease without also requiring the disclosure of contractual commitments for services that are provided as part of other contracts. The IASB decided that adding such a disclosure requirement would be beyond the scope of the Leases project.

Additional disclosures (paragraph 59)

BC224 Many leases contain more complex features, which can include variable payments, termination and extension options and residual value guarantees. These features of a lease are often determined on the basis of the individual circumstances of the parties to the contract and, in some cases, are particularly complex or are unique to the particular contract. The feedback received from stakeholders demonstrated that, for these features of a lessee's lease portfolio, a standard disclosure requirement for all entities is unlikely to meet the needs of users of financial statements.

BC225 With respect to these more complex features, IFRS 16 requires a lessee to disclose any material entity-specific information that is necessary in order to meet the disclosure objective and is not covered elsewhere in the financial statements. IFRS 16 supplements this requirement with a list of user information needs that any additional disclosures should address, and with illustrative examples of disclosures that a lessee might provide in complying with the additional disclosure requirements. The IASB noted that these examples are not exhaustive. Nonetheless, the IASB thinks that the illustrative examples are useful in demonstrating that judgement should be applied in determining the most useful and relevant disclosures, which will depend on a lessee's individual circumstances. In the IASB's view, this approach facilitates the provision of more relevant and useful disclosures by (a) discouraging the use of generic or 'boilerplate' statements; and (b) enabling a lessee to apply judgement to identify the information that is relevant to users of financial statements and focus its efforts on providing that information.

BC226 The IASB acknowledged that, for lessees with many complex, unique or otherwise significant lease arrangements, there are likely to be incremental costs associated with the additional disclosure requirements in paragraph 59 of IFRS 16. However, the IASB thinks that:

(a) the measurement requirements in IFRS 16 are simplified in several ways that are expected to reduce the cost of applying IFRS 16 for a lessee, but also mean that users of financial statements need additional information to understand any significant features that are excluded from the measurement of lease liabilities. For example, a lessee is not required to include payments during optional periods unless those payments are reasonably certain to occur (see paragraphs BC152–BC159). Similarly, a lessee is not required to reassess variable lease payments unless they depend on an index or a rate and there is a change in future lease payments resulting from a change in the reference index or rate (see paragraphs BC188–BC190).

(b) many lessees will not need to provide any additional disclosures as a result of these requirements. This is because the disclosures required by paragraphs 53 and 58 of IFRS 16 are expected to provide sufficient information for those leases that do not have complex or unique features. In the IASB's view, it is appropriate that greater cost will be required in preparing lease disclosures for entities whose leasing activity is particularly complex or unique.

BC227 The IASB considered requiring disclosure of specific information about these more complex features. Such information could have included, for example, the basis and terms and conditions on which variable lease payments and options are determined. However, lessees informed the IASB that this information would be difficult to capture in a meaningful way, particularly for large or diverse lease portfolios. Some users of financial statements also expressed concerns that such an approach could lead to 'boilerplate' compliance statements, which generally do not provide useful information. The approach taken enables lessees to determine the best way to provide information while considering both the costs of providing that information and the information needs of users of financial statements.

Presentation of lessee disclosures in the notes to the financial statements (paragraphs 52 and 54)

BC228 IFRS 16 requires a lessee to disclose information about its leases in a single note or separate section in its financial statements, and to present quantitative information in a tabular format, unless another format is more appropriate. On the basis of feedback from users of financial statements, the IASB thinks that this presentation best conveys an overall understanding of a lessee's lease portfolio and improves the transparency of the information. In the IASB's view, presenting all lessee disclosures in a single note or separate section will often be the most effective way to present information about leases in the systematic manner required by paragraph 113 of IAS 1.

Other approaches considered for lessee disclosure

BC229 Rather than creating specific lease disclosure requirements, the IASB considered an alternative approach whereby a lessee would be required to disclose information about its right-of-use assets applying the disclosure requirements for property, plant and equipment in IAS 16, and information about its lease liabilities applying the disclosure requirements for financial liabilities in IFRS 7. Those supporting this approach thought that it would be consistent with the lessee accounting model in IFRS 16.

BC230 Although noting that there are significant similarities between right-of-use assets and other assets and between lease liabilities and other financial liabilities, the IASB did not adopt this approach because:

(a) it would not provide specific information to users of financial statements about some features of a lessee's lease portfolio that are common in lease arrangements (such as variable payments, options to extend or terminate leases and residual value guarantees). Similarly, it would not provide information about some right-of-use assets and lease liabilities that are not recognised in the balance sheet (such as those arising from short-term leases and leases of low-value assets) as a consequence of some of the simplifications that have been introduced in IFRS 16.

(b) information about a lessee's lease portfolio might be obscured by being included within different disclosures about different types of assets and liabilities. Consequently, this approach might compromise the transparency and usefulness of lease information for users of financial statements.

Lessor: accounting (paragraphs 61–97)

BC231 Paragraphs BC57–BC66 discuss the basis for the IASB's decision to substantially carry forward the IAS 17 lessor accounting requirements. The IASB also decided to carry forward substantially all of the language used in the IAS 17 lessor accounting requirements (with the exception of editorial amendments). Consequently, the significant differences between the lessor accounting requirements in IFRS 16 and those in IAS 17 are primarily a direct consequence of the lessee accounting model in IFRS 16.

Subleases

BC232 IFRS 16 requires an intermediate lessor to account for a head lease and a sublease as two separate contracts, applying both the lessee and lessor accounting requirements. The IASB concluded that this approach is appropriate because in general each contract is negotiated separately, with the counterparty to the sublease being a different entity from the counterparty to the head lease. Accordingly, for an intermediate lessor, the obligations that arise from the head lease are generally not extinguished by the terms and conditions of the sublease.

Classification (paragraph B58)

BC233 The IASB decided that, when classifying a sublease, an intermediate lessor should evaluate the lease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset. This is because:

(a) an intermediate lessor (ie the lessor in a sublease) does not own the underlying asset and does not recognise that underlying asset in its balance sheet. In the IASB's view, the intermediate lessor's accounting should be based on the asset that the intermediate lessor controls (ie the right-of-use asset) and not the underlying asset that is controlled by the head lessor.

(b) an intermediate lessor's risks associated with a right-of-use asset can be converted into credit risk by entering into a sublease, the term of which covers most or all of the term of the head lease. Accounting for such a sublease as a finance lease (by classifying it by reference to the right-of-use asset) would reflect that risk, because the intermediate lessor would recognise the net investment in the sublease (a receivable) rather than a right-of-use asset.

(c) if a sublease is for all of the remaining term of the corresponding head lease, the intermediate lessor no longer has the right to use the underlying asset. In the IASB's view, it is appropriate for an intermediate lessor in such a case to derecognise the right-of-use asset and recognise the net investment in the sublease.

BC234 The IASB observed that, in classifying a sublease by reference to the right-of-use asset arising from the head lease, an intermediate lessor will classify more subleases as finance leases than it would have done if those same subleases were classified by reference to the underlying asset. Accordingly, a lessor may classify similar leases (for example, those with a similar lease term for a similar underlying asset) differently depending on whether the lessor owns or leases the underlying asset. However, the IASB concluded that any difference in classification reflects real economic differences. The intermediate lessor only has a right to use the underlying asset for a period of time. If the sublease is for all of the remaining term of the head lease, the intermediate lessor has in effect transferred that right to another party. In contrast, in an operating lease of an owned asset, the lessor would expect to derive economic benefits from the underlying asset at the end of the lease term.

Presentation

BC235 IFRS 16 does not include requirements relating to the presentation of subleases. This is because the IASB decided that specific requirements were not warranted because there is sufficient guidance elsewhere in IFRS. In particular, applying the requirements for offsetting in IAS 1, an intermediate lessor should not offset assets and liabilities arising from a head lease and a sublease of the same underlying asset, unless the financial instruments requirements for offsetting are met. The IASB considered whether to create an exception that would permit or require an intermediate lessor to offset assets and liabilities arising from a head lease and a sublease of the same underlying asset. However, the IASB noted that the exposures arising from those assets and liabilities are different from the exposures arising from a single net lease receivable or lease liability, and concluded that presenting these on a net basis could provide misleading information about an intermediate lessor's financial position, because it could obscure the existence of some transactions.

BC236 For the same reasons, the IASB also decided that an intermediate lessor should not offset lease income and lease expenses relating to a head lease and a sublease of the same underlying asset, unless the requirements for offsetting in IAS 1 are met.

Initial direct costs (paragraphs 69 and 83)

BC237 IFRS 16 defines initial direct costs consistently with the definition of incremental costs of obtaining a contract in IFRS 15. Defining initial direct costs in this way means that the costs incurred by a lessor to obtain a lease are accounted for consistently with costs incurred to obtain other contracts with customers.

Lease modifications (paragraphs 79–80 and 87)

BC238 IFRS 16 requires a lessor—like a lessee—to account for a modification to a finance lease as a separate lease if:

(a) the modification increases the scope of the lease by adding the right for the lessee to use one or more underlying assets; and

(b) the consideration received for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

This is because, in the IASB's view, such a modification in substance represents the creation of a new lease that is separate from the original lease. This requirement is substantially aligned with equivalent requirements in IFRS 15 that require a seller to account for modifications that add distinct goods or services as separate contracts if those additional goods or services are priced commensurately with their stand-alone selling price.

BC239 For modifications to a finance lease that are not accounted for as a separate lease, IFRS 16 requires a lessor to account for the modification applying IFRS 9 (unless the lease modification would have been classified as an operating lease if the modification had been in effect at the inception date). The IASB expects that this approach will not result in any substantive change to previous lessor accounting for modifications of finance leases. This is because, although IAS 17 did not include requirements relating to lease modifications, the IASB understands that a lessor generally applied an approach that was consistent with the requirements in IFRS 9 (or the equivalent requirements in IAS 39 *Financial Instruments: Recognition and Measurement*) to the net investment in a finance lease.

BC240 IFRS 16 requires a lessor to account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. This approach is consistent with the approach required by IFRS 15 if, at the time of a contract modification (that is accounted for as a separate contract), the remaining goods or services to be transferred are distinct from the goods or services already transferred. It is also expected that this approach will not result in any substantive change to previous lessor accounting.

Lessor: classification of leases—leases of land and buildings (2003 and 2009 amendments to IAS 17) (paragraphs B55–B57)

Land element in long-term leases

BCZ241 In 2009, the IASB amended the IAS 17 requirements for classification of the land element in long-term leases. IAS 17 had previously stated that a lease of land with an indefinite economic life would normally be classified as an operating lease. However, in 2009, the IASB removed that statement from IAS 17, having concluded that it might lead to a classification of land that does not reflect the substance of the transaction.

BCZ242 In reaching this conclusion the IASB had considered the example of a 999-year lease of land and buildings. It had noted that, for such a lease, significant risks and rewards associated with the land during the lease term would have been transferred by the lessor despite there being no transfer of title.

BCZ243 The IASB had also noted that the lessor in leases of this type will typically be in a position economically similar to an entity that sold the land and buildings. The present value of the residual value of the property in a lease with a term of several decades would be negligible. The IASB had concluded that the accounting for the land element as a finance lease in such circumstances would be consistent with the economic position of the lessor.

BCZ244 The IASB replaced the previous guidance with a statement (now in paragraph B55 of IFRS 16) that, in determining whether the land element is an operating lease or a finance lease, an important consideration is that land normally has an indefinite economic life.

Allocation of lease payments between land and buildings

BCZ245 In 2003, the IASB introduced into IAS 17 the requirement for a lessor to assess the classification of the land element of a lease separately from the buildings element. The Exposure Draft of the 2003 amendments had further proposed that, whenever necessary for the purposes of classification, the lease payments should be allocated between the land and building elements in proportion to their relative fair values at the inception of the lease. However, respondents to that Exposure Draft had questioned whether the relevant fair values were the fair values of the underlying land and buildings or the fair values of the leasehold interests in the land and buildings.

BCZ246 In redeliberating that Exposure Draft, the IASB noted that an allocation of the lease payments by reference to the relative fair values of the underlying land and buildings would not reflect the fact that land often has an indefinite economic life, and therefore would be expected to maintain its value beyond the lease term. In contrast, the future economic benefits of a building are likely to be used up, at the least to some extent, over the lease term. Therefore, it would be reasonable to expect that the lease payments relating to the building would be set at a level that enabled the lessor not only to make a return on initial investment, but also to recoup the value of the building used up over the term of the lease. In the case of land, the lessor would not normally need compensation for using up the land.

BCZ247 Therefore, the IASB decided to clarify in the 2003 amendments that the allocation of the lease payments is weighted to reflect their role in compensating the lessor, and not by reference to the relative fair values of the underlying land and buildings. In other words, the weighting should reflect the leasehold interest in the land element and the buildings element of the lease at the inception date. In the extreme case that a building is fully depreciated over the lease term, the lease payments would need to be weighted to provide a return plus the full depreciation of the building's value at the inception of the lease. The leasehold interest in the land would, assuming a residual value that equals its value at the inception of the lease, have a weighting that reflects only a return on the initial investment. These clarifications are now in paragraph B56 of IFRS 16.

Impracticability of split between land and buildings

BCZ248 When amending IAS 17 in 2003, the IASB considered how to treat leases for which it is not possible to measure the two elements reliably (for example, because similar land and buildings are not sold or leased separately). One possibility would be to classify the entire lease as a finance lease. However, the IASB noted that it may be apparent from the circumstances that classifying the entire lease as a finance lease is not representationally faithful. In view of this, the IASB decided that when it is not possible to measure the two elements reliably, the entire lease should be classified as a finance lease unless it is clear that both elements should be classified as an operating lease. This requirement is now in paragraph B56 of IFRS 16.

Exception to the requirement to separate the land and buildings elements

BCZ249 When amending IAS 17 in 2003, the IASB discussed whether to allow or require an exception from the requirement to separate the land and buildings elements in cases in which the present value of the land element at the inception of the lease is small in relation to the value of the entire lease. In such cases the benefits of separating the lease into two elements and accounting for each separately may not outweigh the costs. The IASB noted that generally accepted accounting principles in Australia, Canada and the US allow or require such leases to be classified and accounted for as a single unit, with finance lease treatment being used when the relevant criteria are met. The IASB decided to allow land and buildings to be treated as a single unit when the land element is immaterial. This exception is now in paragraph B57 of IFRS 16.

BCZ250 Some stakeholders requested guidance on how small the relative value of the land element needs to be in relation to the total value of the lease. The IASB decided not to introduce a bright line such as a specific percentage threshold. The IASB decided that the normal concepts of materiality should apply.

Lessor: disclosure (paragraphs 89–97)

BC251 IFRS 16 enhances the previous lessor disclosure requirements in IAS 17 to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities. The enhancements are in response to views expressed by some stakeholders that the lessor accounting model in IAS 17 did not provide sufficient information relating to all elements of a lessor's leasing activities. In particular, some investors and analysts requested additional information about a lessor's exposure to residual asset risk.

Table of income (paragraphs 90–91)

BC252 IFRS 16 requires a lessor to disclose information about the different components of lease income recognised during the reporting period. This requirement is similar to the requirement in IFRS 15 for an entity to disclose a disaggregation of revenue recognised during the reporting period into categories.

Information about residual asset risk (paragraph 92(b))

BC253 Academic research, outreach performed and feedback received throughout the project highlighted that the main concern associated with lessor disclosure in IAS 17 was the lack of information about a lessor's exposure to credit risk (associated with the lease payments receivable from the lessee) and asset risk (associated with the lessor's residual interest in the underlying asset). Particularly for leases classified as operating leases, lessors could retain significant residual asset risk and little, if any, information was generally available about that exposure to risk in the financial statements.

BC254 A decline in the market value of, for example, leased equipment and vehicles at a rate greater than the rate the lessor projected when pricing the lease would adversely affect the profitability of the lease. Uncertainty about the residual value of the underlying asset at the end of the lease is often a lessor's primary risk. Accordingly, IFRS 16 requires a lessor to disclose information about how it manages its risk associated with any rights it retains in the underlying asset. The IASB also noted that disclosing information about residual asset risk will also provide users of financial statements with useful information about the distribution of risk for a lessor between credit risk relating to lease payments receivable and residual asset risk related to the interest in the underlying asset.

BC255 The IASB considered requiring a lessor to disclose the fair value of residual assets at each reporting date. However, the IASB concluded that such a requirement could be onerous for lessors. Although it is fundamental to a lessor's business that the lessor manage its exposure to residual asset risk, the IASB thought that the costs associated with having to disclose, and have audited, fair value information about residual assets would outweigh the benefit for users of financial statements.

Information about assets subject to operating leases (paragraphs 95–96)

BC256 The IASB observed that a lessor accounts for assets leased under operating leases similarly to owned assets that are held and used (for example, in the lessor's operations). However, leased and owned assets are typically used for different purposes—ie leased assets generate rental income rather than contributing towards any other revenue-generating activity of the lessor. For that reason, the IASB concluded that users of financial statements would benefit from obtaining information about leased assets that generate rental income separately from owned assets held and used by the lessor. Consequently, IFRS 16 requires a lessor to disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases.

Maturity analyses (paragraphs 94 and 97)

BC257 IFRS 16 requires a lessor to disclose a maturity analysis of the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years following the reporting date and a total of the amounts for the remaining years.

BC258 The IASB noted that this requirement would provide more information about a lessor's liquidity risk than previous requirements in IAS 17 (which had, instead, required a maturity analysis showing lease payments due in three bands: within one year, in the second to fifth years and after five years). In the IASB's view, a more detailed maturity analysis will enable users of financial statements to more accurately forecast future lease cash flows and estimate liquidity risk. The IASB does not expect the incremental cost (compared to the IAS 17 requirements) to be significant because lessors typically needed the same information to provide the disclosures required by IAS 17. The IASB also noted that some lessors had already disclosed a maturity analysis relating to lease payments to be received in more detail than was required by IAS 17.

Changes in net investment in finance leases (paragraph 93)

BC259 IFRS 16 requires a lessor to provide a qualitative and quantitative explanation of the significant changes in the net investment in finance leases during the reporting period to allow users of financial statements to understand these significant changes. On the basis of the feedback received, the IASB concluded that this information is useful to users of financial statements and is not otherwise available.

Sale and leaseback transactions (paragraphs 98–103)

BC260 In a sale and leaseback transaction, one entity (the seller-lessee) transfers an asset to another party (the buyer-lessor) and leases back that same asset. IAS 17 included specific requirements on sale and leaseback transactions and the IASB decided that it would be helpful to continue to include specific requirements for sale and leaseback transactions in IFRS 16.

When a sale occurs

BC261 The IASB decided that, within the context of a sale and leaseback transaction, the transfer of an asset is accounted for as a sale only if the transfer meets the requirements in IFRS 15 for the transfer of an asset. In the IASB's view, applying the recognition requirements of IFRS 15 to sale and leaseback transactions will be beneficial for both preparers and users of financial statements because it will increase comparability between sales entered into as part of sale and leaseback transactions and all other sales. The IASB observed that, in considering whether a transaction should be accounted for as a sale and leaseback transaction, an entity should consider not only those transactions structured in the form of a legal sale and leaseback, but should also consider other forms of transactions for which the economic effect is the same as a legal sale and leaseback (for example, a sale and leaseback transaction may be structured in the form of a lease and leaseback).

BC262 In reaching its decisions on sale and leaseback transactions, the IASB noted that:

(a) the presence of a leaseback (ie the seller-lessee obtaining the right to use the underlying asset for a period of time) does not, in isolation, preclude the seller-lessee from concluding that it has transferred the underlying asset to the buyer-lessor. This is because a lease is different from the purchase or sale of the underlying asset, in that a lease does not transfer control of the underlying asset to the lessee; instead, it transfers the right to control the use of the underlying asset for the period of the lease. Consequently, if there are no features in a sale and leaseback transaction that prevent sale accounting, the buyer-lessor is considered to obtain control of the underlying asset, and immediately transfer the right to control the use of that asset to the seller-lessee for the lease term. The fact that the buyer-lessor purchases the underlying asset from the entity that is the lessee in the subsequent leaseback does not change the buyer-lessor's ability to obtain control of the underlying asset.

(b) many lessors purchase from a third party an asset that will be the subject of a lease only when the terms and conditions of the lease have already been negotiated. The lessor may not receive physical possession of the asset until the end of the lease term (for example, a vehicle could be delivered directly by a manufacturer to the lessee, even though the lessor purchases the vehicle from the manufacturer). Similarly, the buyer-lessor may not receive physical possession of the underlying asset in a sale and leaseback transaction until the end of the lease term. In the IASB's view, these circumstances do not, in isolation, preclude the seller-lessee from concluding that it has transferred the underlying asset to the buyer-lessor. In both cases, the IASB concluded that it is appropriate for the lessor to be deemed to control the asset immediately before the commencement date (if the sale of the underlying asset otherwise meets the requirements in IFRS 15 for the transfer of an asset).

(c) IFRS 15 states that if an entity has a right to repurchase an asset (a call option), the customer does not obtain control of the asset, because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from the asset, even though the customer may have physical possession of the asset. Consequently, if the seller-lessee has a substantive repurchase option with respect to the underlying asset, then no sale has occurred.

BC263 The IASB considered, but did not adopt, an alternative approach whereby IFRS 16 would require a higher threshold than the IFRS 15 threshold for recognising a sale within the context of a sale and leaseback transaction because many stakeholders expressed concerns about such an approach. In particular, they questioned the rationale for having a higher threshold for sale accounting in a sale and leaseback transaction than for any other sale. Some were also of the view that different thresholds for achieving sale accounting in IFRS 15 and IFRS 16 would not be operational. The IASB also noted that some of the structuring concerns relating to sale and operating leaseback transactions that had existed under IAS 17 would be substantially reduced by the lessee accounting model in IFRS 16, which requires the recognition of lease assets and lease liabilities by the seller-lessee.

BC264 The IASB considered whether to include additional application guidance in IFRS 16 regarding the determination of whether there is a sale in a sale and leaseback transaction. Such guidance would be intended to help entities to apply the IFRS 15 requirements relating to the satisfaction of performance obligations to sale and leaseback transactions. However, the IASB concluded that this was not necessary because, in its view, the principles in IFRS 15 can be applied appropriately and consistently to sale and leaseback transactions without any further guidance.

BC265 The IASB also decided that, if the transfer of the asset does not meet the requirements for a transfer in IFRS 15, then no sale is recognised by the seller-lessee and no purchase is recognised by the buyer-lessor. Instead, the seller-lessee and buyer-lessor will account for any amounts received or paid relating to the leaseback as a financial asset or a financial liability applying IFRS 9. This is because such a transaction represents, in substance, a financing arrangement.

Gain or loss on a sale and leaseback

BC266 The IASB decided that the gain or loss recognised by a seller-lessee on a completed sale in a sale and leaseback transaction should reflect the amount that relates to the rights transferred to the buyer-lessor. In reaching this decision, the IASB considered requiring the sale element of the transaction (ie the sale of the underlying asset) to be accounted for applying IFRS 15 because, from a legal standpoint, the seller-lessee will often have sold the entire underlying asset to the buyer-lessor. However, from an economic standpoint, the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback—it has retained its right to use the asset for the duration of the leaseback. The seller-lessee had already obtained that right to use the asset at the time that it purchased the asset—the right of use is an embedded part of the rights that an entity obtains when it purchases, for example, an item of property, plant and equipment. Accordingly, in the IASB's view, recognising the gain that relates to the rights transferred to the buyer-lessor appropriately reflects the economics of the transaction.

BC267 The lease payments and the sale price in a sale and leaseback transaction are typically interdependent because they are negotiated as a package. For example, the sale price might be more than the fair value of the asset because the leaseback rentals are above a market rate; conversely the sale price might be less than the fair value because the leaseback rentals are below a market rate. Accounting for the transaction using those amounts could result in the misstatement of gains or losses on disposal of the asset for the seller-lessee and the misstatement of the carrying amount of the asset for the buyer-lessor. Consequently, IFRS 16 requires that if the sale consideration or leaseback rentals are not at market rates, any below-market terms should be accounted for as a prepayment of lease payments and any above-market terms should be accounted for as additional financing provided by the buyer-lessor to the seller-lessee. Similarly, IFRS 16 requires the seller-lessee to measure the right-of-use asset as a proportion of the asset retained as a result of the leaseback—consequently any off-market terms are effectively accounted for in measuring the gain or loss on sale.

Effective date and early application (paragraph C1)

BC268 In determining the effective date of IFRS 16, the IASB considered feedback received from preparers about the amount of time they would need to implement the requirements of IFRS 16 in the light of the transition requirements. The IASB also considered feedback received from both users and preparers of financial statements about the interaction of IFRS 16 with the implementation of other recently issued Standards (most notably IFRS 9 and IFRS 15).

BC269 The IASB acknowledged that users of financial statements would generally prefer the effective date of IFRS 16 to be 1 January 2018. This is because users would prefer IFRS 16 to have the same effective date as IFRS 9 and IFRS 15—this would avoid accounting uncertainty arising from entities implementing new Standards over a number of years. Users of financial statements also noted that, in their view, the effective date of IFRS 16 should be as soon as possible in the light of the significant improvements in financial reporting that will result from the implementation of IFRS 16. Consequently, they did not support a period of three years between publication of IFRS 16 and the effective date.

BC270 However, almost all preparers that provided feedback indicated that an effective date of 1 January 2018 would not give them adequate time to implement IFRS 16, IFRS 9 and IFRS 15. The majority of preparers reported that they would need approximately three years to implement the requirements of IFRS 16 between publication and the effective date.

BC271 The IASB concluded that implementation of IFRS 16 by 1 January 2018 would not be achievable for all preparers taking into consideration that entities are also required to implement IFRS 9 and IFRS 15 in that period of time. Consequently, the IASB decided that an entity is required to apply IFRS 16 for annual reporting periods beginning on or after 1 January 2019.

BC272 The IASB also decided to permit early application of IFRS 16 for entities that apply IFRS 15 on or before the date of initial application of IFRS 16. In reaching this decision, the IASB noted that early application would allow any entity that wishes to apply IFRS 16 at the same time as IFRS 9 and IFRS 15 to do so. The IASB also noted that early application might be beneficial to an entity that adopts IFRS for the first time between the publication of IFRS 16 and its effective date. However, the IASB decided to limit early application of IFRS 16 to entities that also apply IFRS 15. This is because some of the requirements of IFRS 16 depend on an entity also applying the requirements of IFRS 15 (and not the Standards that were superseded by IFRS 15).

Transition (paragraphs C2–C20)

Definition of a lease (paragraphs C3–C4)

BC273 The IASB decided that an entity is not required to reassess whether contracts are, or contain, leases on transition to IFRS 16. Consequently, an entity can choose to apply the requirements of IFRS 16 to all existing contracts that met the definition of a lease applying the requirements of IAS 17 and IFRIC 4. Similarly, an entity does not need to apply IFRS 16 to existing contracts that did not meet the definition of a lease applying the requirements of IAS 17 and IFRIC 4.

BC274 Preparers provided feedback that it could be costly for them to reassess all of their existing contracts using the definition of a lease requirements in IFRS 16. The IASB observed that it envisages only a limited number of scenarios in which application of the lease definition requirements in IFRIC 4 would result in a different outcome from the application of the lease definition guidance in IFRS 16. The IASB identified a small population of contracts that would be classified as leases applying IFRIC 4 but as service contracts applying IFRS 16, and none for which the converse is expected to be true. The IASB expects that the consequence of an entity not reassessing its existing contracts applying the lease definition requirements in IFRS 16 would be the recognition of slightly more leases on transition to IFRS 16 than would otherwise be the case. On this basis, the IASB concluded that the costs of requiring entities to reassess existing contracts applying the lease definition guidance in IFRS 16 would not be justified.

Lessees (paragraphs C5–C13)

BC275 The IASB decided that, on transition, a lessee should apply IFRS 16 using either of the following methods:

(a) retrospectively to each prior reporting period presented applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or

(b) retrospectively with the cumulative effect of initially applying IFRS 16 recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application. The IASB decided that, applying this approach, a lessee is permitted to apply some optional practical expedients on a lease-by-lease basis (see paragraphs BC282–BC287).

BC276 The IASB decided not to require a full retrospective approach for all lessees because the costs of such an approach could be significant and would be likely to outweigh the benefits. A full retrospective approach would require entities to determine the carrying amounts of all leases in existence at the earliest comparative period as if those leases had always been accounted for applying IFRS 16 and to restate comparative information. That could be impracticable for entities that have thousands of leases. Nonetheless, the IASB did not wish to prohibit entities from applying a full retrospective approach, because that approach would provide better information to users of financial statements than other approaches. Consequently, the IASB decided to permit entities to choose to apply IFRS 16 fully retrospectively with restatement of comparative information.

BC277 The IASB also rejected a prospective approach (ie applying IFRS 16 only to leases that commence after the date of transition). Although such an approach would be the least costly for preparers to apply, the information provided would not be beneficial for users of financial statements, particularly for entities that enter into long-term operating leases. For example, some entities enter into operating leases with lease terms of 20 to 30 years. For such entities, a user would not obtain the full benefits of IFRS 16 or full comparability of lease accounting for up to 30 years after implementing the new requirements, because the accounting for leases during that period would not be consistent. This is because right-of-use assets and lease liabilities would not be recognised for leases that were previously classified as operating leases applying IAS 17.

Retrospective application with the cumulative effect recognised at the date of initial application

BC278 In the 2010 and 2013 Exposure Drafts, the IASB had proposed simplifying the full retrospective approach by introducing a number of practical expedients on transition (some of which are included in IFRS 16). However, feedback from preparers indicated that, although helpful, the practical expedients proposed in the 2010 and 2013 Exposure Drafts would mitigate little of the implementation challenge of a retrospective transition approach. Furthermore, although users of financial statements find the trend information from restated comparative periods useful, many also acknowledged that the costs of full retrospective application with restatement of comparative information would be significant for many lessees and might not be justified.

BC279 In the light of this feedback, the IASB decided to allow an entity to apply IFRS 16 retrospectively (with some practical expedients), with the cumulative effect of initially applying IFRS 16 recognised at the date of initial application (referred to as the 'cumulative catch-up' transition method). The IASB observed that the cumulative catch-up transition method responds to feedback from stakeholders by eliminating the need to restate financial information in comparative periods on transition and thereby reducing costs. The cost of restating comparative data could be significant because the implementation of IFRS 16 affects a number of elements of the financial statements.

BC280 Because comparative information will not be restated under the cumulative catch-up transition method, the IASB decided to require additional disclosures to help users of financial statements to understand the effect of applying IFRS 16 for the first time. Consequently, IFRS 16 requires an entity using the cumulative catch-up transition method to disclose information on transition about leases that were previously classified as operating leases. This disclosure requirement replaces the requirements of paragraph 28(f) of IAS 8—ie a lessee applying the cumulative catch-up transition method is not required to disclose the amount of the adjustment to each financial statement line item that is normally required by IAS 8 on initial application of a new Standard.

BC281 The IASB observed that the cumulative catch-up transition method and the required disclosures mean that a lessee does not need to operate two different sets of accounting requirements at any point. Consequently, the IASB concluded that this approach would substantially reduce the overall cost of implementing IFRS 16 while enabling information to be provided to users of financial statements to explain the effect of the change in accounting for leases previously classified as operating leases.

Leases previously classified as operating leases

BC282 To reduce the costs of implementing IFRS 16, the IASB decided to introduce a number of additional practical expedients relating to leases previously classified as operating leases for a lessee that adopts the cumulative catch-up transition method.

Right-of-use assets (paragraph C8(b))

BC283 Determining the measurement of the right-of-use asset under a retrospective approach could be onerous, because it would require a lessee to determine the initial measurement of the lease liability for leases that may have commenced many years before transition to IFRS 16. Consequently, the 2010 Exposure Draft proposed that the right-of-use asset should be measured at an amount equal to the lease liability on transition, adjusted for any impairment. However, many stakeholders noted that this approach would increase lease-related costs artificially in the years immediately following transition to IFRS 16 (because the depreciation charge would typically be higher than if IFRS 16 had always been applied). These stakeholders thought that the artificial increase in the depreciation charge immediately after transition would distort the financial information provided to users of financial statements.

BC284 In response to this feedback, the 2013 Exposure Draft proposed that a lessee calculate right-of-use assets in a similar manner to a full retrospective approach, but using information available at the date of transition. However, many preparers thought that the cost of capturing historical information, such as lease start dates and historical payment schedules, would still be significant—particularly for entities with a high volume of leases.

BC285 On the basis of the feedback received, the IASB concluded that it is not possible to provide one method of measuring the right-of-use asset on transition that would (a) avoid an artificial higher expense related to leases following initial application of IFRS 16; and (b) address the cost concerns of preparers. Consequently, the IASB decided to permit lessees to choose, on a lease-by-lease basis, how to measure the right-of-use asset on transition to IFRS 16. Paragraph C8(b) permits a lessee either to measure the right-of-use asset as if IFRS 16 had always been applied or to measure the right-of-use asset at an amount equal to the lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments).

BC286 Although acknowledging that a choice of approach could result in reduced comparability, the IASB concluded that permitting a choice of measurement approaches for the right-of-use asset on transition to IFRS 16 should be largely 'self-policing' in terms of application. This is because the effect of the less costly option (measuring the right-of-use asset equal to the lease liability, adjusted by the amount of any previously recognised prepaid or accrued lease payments) is an increase in operating expense (ie higher depreciation) for the remainder of the term of the lease. The IASB concluded that a lessee is expected to select the less costly option only for leases for which the costs of applying a more accurate transition approach outweigh the benefit of achieving a 'correct' post-transition income statement. The IASB expects this to apply to leases that are high in volume but low in value but not to leases such as long-term leases of property or large equipment.

Other practical expedients

BC287 To further ease the costs on transition, the IASB also decided to allow a lessee to elect to use one or more of the following practical expedients.

Practical expedient	**Rationale**
Portfolio approach	
A lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics.	The IASB expects that permitting a lessee to apply a single discount rate to a portfolio of similar leases on transition will provide cost savings to lessees and will not have a significant effect on reported information. For leases for which the right-of-use asset is measured at an amount equal to the lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments) on the date of initial application (see paragraph BC285), this practical expedient will enable a lessee to apply the transition requirements collectively to portfolios of leases of similar assets in similar economic environments with the same end date.
Previously recognised onerous lease provisions	
A lessee may rely on its assessment of whether leases are onerous applying IAS 37 immediately before the date of initial application and adjust the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised immediately before the date of initial application. This approach is an alternative to performing an impairment review.	It could be costly for a lessee to perform an impairment review of each of its right-of-use assets on transition to IFRS 16. In addition, any onerous operating lease liability identified applying IAS 37 is likely to reflect impairment of the right-of-use asset. Accordingly, the IASB concluded that this practical expedient will provide a cost saving to lessees on initial application of IFRS 16 without any significant effect on reported information.

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Practical expedient	Rationale
Leases for which the lease term ends within 12 months	
A lessee may elect not to apply the requirements of IFRS 16 to leases for which the term ends within 12 months of the date of initial application.	For a lessee that does not restate its comparative information, leases for which the term ends within 12 months of the date of initial application are very similar in effect to those captured by the short-term lease exemption and thus similar considerations apply (see paragraphs BC87–BC97). In addition, feedback from lessees indicated that this practical expedient will provide a significant cost saving on initial application of IFRS 16.
Initial direct costs	
A lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.	The IASB expects that including initial direct costs in the measurement of right-of-use assets would not have a significant effect on reported information. Consequently, the IASB decided that the cost for lessees of requiring initial direct costs to be identified and included in the measurement of right-of-use assets would outweigh the benefits in terms of reported information.
Use of hindsight	
A lessee may use hindsight in applying IFRS 16, for example, in determining the lease term if the contract contains options to extend or terminate the lease.	Permitting lessees to apply hindsight on transition to IFRS 16 will result in useful information, particularly with respect to areas of judgement such as the determination of lease term for contracts that contain options to extend or terminate a lease. Feedback from stakeholders also indicated that permitting the use of hindsight will make initial application of IFRS 16 somewhat simpler for lessees.

Leases previously classified as finance leases (paragraph C11)

BC288 The lessee accounting model in IFRS 16 is similar to the accounting requirements for finance leases in IAS 17. Consequently, IFRS 16 does not contain detailed transition requirements for leases previously classified as finance leases if a lessee elects to apply the cumulative catch-up transition approach. For these leases, IFRS 16 requires a lessee to measure the carrying amount of the right-of-use asset and the lease liability at the date of initial application of IFRS 16 as the carrying amount of the lease asset and lease liability immediately before that date applying the finance lease accounting requirements in IAS 17.

Lessors (paragraphs C14–C15)

BC289 The lessor accounting requirements in IFRS 16 are substantially unchanged from those in IAS 17. Consequently, the IASB decided that a lessor is not required to make any adjustments on transition and should account for its leases applying IFRS 16 from the date of initial application (except for intermediate lessors in a sublease—see paragraphs BC290–BC291).

BC290 Subleases that were classified by an intermediate lessor as operating leases applying IAS 17 may be classified as finance leases applying IFRS 16. This is because IFRS 16 requires an intermediate lessor to evaluate the classification of a sublease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset as was required by IAS 17. If an intermediate lessor were to continue to apply previous operating lease accounting to these subleases, it would recognise the right-of-use asset arising from the head lease, despite the fact that, in effect, it no longer has a right to use the underlying asset. The IASB thought that this could be misleading for users of financial statements.

BC291 Consequently, IFRS 16 requires an intermediate lessor to reassess a sublease that was classified as an operating lease applying IAS 17 at the date of initial application to determine whether the sublease should be classified as an operating lease or a finance lease applying IFRS 16, and to account for it accordingly.

Sale and leaseback transactions before the date of initial application (paragraphs C16–C18)

BC292 In response to feedback from stakeholders, the IASB decided to provide transition requirements for sale and leaseback transactions that are consistent with the general transition requirements for all leases. Consequently, a seller-lessee should not perform any retrospective accounting specific to the sale element of a sale and leaseback transaction on transition to IFRS 16. A seller-lessee is required to account for the leaseback on transition to IFRS 16 in the same way as it accounts for any other lease that is in existence at the date of initial application.

BC293 The IASB considered requiring a lessee to reassess historic sale and leaseback transactions to determine whether the transfer would have been accounted for as a sale applying IFRS 15. However, the IASB concluded that the costs of performing the reassessment would not be justified.

BC294 The IASB also decided that a seller-lessee should apply the approach to gain or loss recognition on sale and leaseback transactions in IFRS 16 (described in paragraph BC266) only to sale and leaseback transactions entered into after the date of initial application of IFRS 16. The IASB concluded that the costs of applying a retrospective approach would outweigh the benefits in terms of reported information.

Consequential amendments

Investment property

BC295 IFRS 16 amends the scope of IAS 40 by defining investment property to include both owned investment property and investment property held by a lessee as a right-of-use asset. A summary of the IASB's considerations in developing the amendments to the scope of IAS 40 is described in paragraphs BC178–BC181.

Business combinations

BC296 The IASB decided that when the acquiree in a business combination is a lessee, the acquirer should measure the acquiree's lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the date of acquisition. The acquiree's right-of-use asset should be measured at an amount equal to the lease liability, with an adjustment for any off-market terms present in the lease.

BC297 The IASB considered whether an acquirer should be required to follow the general principle in IFRS 3 *Business Combinations* and measure the acquiree's right-of-use assets and lease liabilities at fair value on the date of acquisition. However, in the IASB's view, the costs associated with measuring lease assets and lease liabilities at fair value would outweigh the benefits because obtaining fair value information might be difficult and, thus, costly. The IASB also noted that, when the acquiree is a lessee, the requirements of IFRS 3 (as amended by IFRS 16) for the measurement of lease assets and lease liabilities would result in the recognition of a net carrying amount for the lease at the date of acquisition that approximates the fair value of the lease at that date.

BC298 The IASB also considered whether to require an acquirer to recognise assets and liabilities relating to any off-market terms if an acquiree is the lessee in a lease for which either the short-term lease or low-value asset lease exemptions described in paragraph 5 of IFRS 16 are applied. Such a requirement would be consistent with the general principles of IFRS 3, under which assets and liabilities relating to contracts with off-market terms are recognised separately in the balance sheet and not subsumed within goodwill on acquisition. However, the IASB observed that the effect of any such off-market terms would rarely be material for short-term leases and leases of low-value assets. Consequently, it decided not to include this requirement in IFRS 3.

Transition for first-time adopters of IFRS

BC299 The IASB considered whether the transition relief for lessees in paragraphs C2–C19 of IFRS 16 should also apply to lessees applying IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

BC300 The IASB decided that a first-time adopter of IFRS should be permitted to apply some of the transition reliefs available to an existing IFRS preparer. This is because first-time adopters will face issues similar to those faced by existing IFRS preparers, and the transition requirements provide relief when first applying the requirements of IFRS 16. However, the IASB decided that a first-time adopter is not permitted to apply those transition reliefs that depend upon the lease having previously been accounted for applying IAS 17. This is because the IASB is not aware of, nor is it possible to consider, the accounting for leases required by every other GAAP. The amounts recognised in accordance with other GAAPs could be significantly different from the amounts recognised applying IAS 17 and IFRS 16.

BC301 The IASB also decided that a first-time adopter should apply IFRS 16 at the date of transition to IFRSs as defined in IFRS 1. Accordingly, a first-time adopter is not able to apply the transition relief provided in IFRS 16, which permits a lessee not to restate comparative information. A first-time adopter is required to restate comparative information applying IFRS 1 for all elements of its financial statements. For this reason, the IASB concluded that it would be inconsistent and impractical for a first-time adopter to not restate comparative information about leases in its first IFRS financial statements.

BC302 The IASB also decided not to permit a first-time adopter of IFRS to apply the transition relief in IFRS 16 for leases classified as finance leases applying IAS 17. The transition relief in IFRS 16 requires an IFRS preparer to measure the carrying amount of the right-of-use asset and the lease liability at the date of initial application of IFRS 16 as the carrying amount immediately before that date applying IAS 17. The rationale for this requirement is that the requirements of IAS 17 for leases classified as finance leases were similar to the requirements of IFRS 16. However, as described in paragraph BC300 above, the IASB cannot consider the accounting required by every other GAAP for leases that would have been classified as finance leases applying IAS 17. Consequently, the IASB concluded that carrying forward a first-time adopter's previous accounting could be misleading to users of financial statements, and could result in a lack of comparability with other IFRS preparers, perhaps for many years after first implementing IFRS.

Comparison with FASB decisions

BC303 The IASB and the FASB reached different decisions about the lessee accounting model. The differences largely affect leases that were previously classified as operating leases. There are a number of other differences between IFRS 16 and the decisions made by the FASB, primarily because of the different decisions reached on the lessee accounting model. The following paragraphs set out the main differences between IFRS 16 and the decisions made by the FASB.

Lessee accounting model

BC304 IFRS 16 applies a single lessee accounting model, which views all leases recognised in the balance sheet as providing finance. The IASB's reasons are explained in paragraphs BC41–BC56. The FASB decided upon a dual lessee accounting model that requires a lessee to classify leases in a similar manner to the previous US GAAP requirements for distinguishing between operating leases and capital leases. Under the FASB lessee accounting model, a lessee:

(a) accounts for finance leases (ie leases previously classified as capital leases) similarly to the IASB model; and

(b) accounts for operating leases by:

(i) recognising right-of-use assets and lease liabilities;

(ii) measuring lease liabilities in the same way as they would be measured applying IFRS 16, but without a requirement to reassess variable lease payments;

(iii) recognising a single lease expense typically on a straight-line basis over the lease term; and

(iv) presenting total cash paid within operating activities in the statement of cash flows.

Subleases

BC305 IFRS 16 requires an intermediate lessor to classify a sublease as either an operating lease or a finance lease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset. The IASB's reasons are explained in paragraphs BC233–BC234. The FASB decided to require an intermediate lessor to determine the classification of the sublease by reference to the underlying asset.

Sale and leaseback transactions

BC306 In a sale and leaseback transaction, IFRS 16 requires a seller-lessee to recognise only the amount of any gain or loss on sale that relates to the rights transferred to the buyer-lessor. The IASB's reasons are explained in paragraph BC266. The FASB decided to require a seller-lessee to account for any gain or loss on sale consistently with the guidance that would apply to any other sale of an asset.

Presentation, disclosure and transition

BC307 There are a number of differences between the presentation, disclosure and transition requirements of IFRS 16 and the decisions made by the FASB. These differences are primarily a consequence of either the differences between the lessee accounting models or differences between other requirements of IFRS and US GAAP that are relevant to leases (for example, differences in the general disclosure requirements applicable to financial liabilities).

Recognition exemption for leases of low-value assets

BC308 IFRS 16 permits a lessee not to apply the recognition requirements to leases for which the underlying asset is of low value. The IASB's reasons are explained in paragraphs BC98–BC104. The FASB decided not to include such an exemption.

Reassessment of variable lease payments

BC309 IFRS 16 requires a lessee to reassess variable lease payments that depend on an index or a rate when there is a change in the future lease payments resulting from a change in the reference index or rate. The IASB's reasons are explained in paragraphs BC188–BC190. The FASB decided not to include any requirements to reassess variable lease payments.

Lessor accounting

BC310 Both the IASB and the FASB decided to substantially carry forward the previous lessor accounting requirements in IAS 17 and Topic 840 respectively.

Consequently, there are a number of differences between the lessor accounting requirements in IFRS 16 and the decisions made by the FASB that are effectively carried forward from previous lessor accounting requirements.

Dissenting Opinion

Dissent of Wei-Guo Zhang

DO1 Mr Zhang supports the lessee accounting requirements in IFRS 16. However, Mr Zhang voted against publication of IFRS 16 for the following reasons:

(a) firstly, Mr Zhang does not support retaining a dual accounting model for lessors while requiring a single accounting model for lessees; and

(b) secondly, Mr Zhang disagrees with the recognition exemption for leases of low-value assets.

Lessor accounting

DO2 Mr Zhang agrees with the right-of-use lessee accounting model and believes that it should be applied symmetrically to lessor accounting. Mr Zhang is of the view that a lessor should recognise a lease receivable and a residual asset for all leases for which a lessee recognises a lease liability and a right-of-use asset. He believes that it is conceptually inconsistent to require a single accounting model for lessees while retaining a dual accounting model for lessors.

DO3 Mr Zhang agrees with the IASB's view set out in paragraphs BC35–BC36 that a lessor's right to receive lease payments arising from a lease is a financial asset. Mr Zhang believes that this financial asset should be reflected as such in a lessor's financial statements, and thus Mr Zhang disagrees with the conclusions reached in paragraphs BC57–BC66 regarding the costs and benefits of changing the lessor accounting model in IAS 17. This is because the nature of the risks associated with a financial asset are different from those of the underlying asset, and information about those different risks is of great importance to users of a lessor's financial statements.

DO4 Additionally, Mr Zhang is concerned about the complexity and potential for misapplication of the dual lessor accounting model. Mr Zhang acknowledges that this dual model is consistent with the requirements in IAS 17. However, Mr Zhang notes that one of the biggest criticisms of IAS 17 was the potential for complexity and structuring inherent in a dual model. Mr Zhang believes that two transactions that are economically the same could be structured in a way that results in those transactions being accounted for differently under the dual lessor accounting model.

Leases of low-value assets

DO5 Mr Zhang also disagrees with the recognition exemption for leases of low-value assets of a lessee because he does not believe that these leases should be treated differently from a lessee's other leases.

DO6 Mr Zhang believes that the recognition exemption for leases of low-value assets is unnecessary. This is because, in his view, the materiality guidance in IFRS and the recognition exemption for short-term leases in IFRS 16 should be sufficient to identify those leases for which the costs of recognising assets and liabilities would outweigh the benefits. When leases of low-value assets are material in the aggregate, Mr Zhang believes that recognising assets and liabilities has significant benefit. Mr Zhang also thinks that the costs of recognising assets and liabilities would be mitigated because an entity would have a record of leases of low-value assets for internal control purposes. The only incremental cost might be the cost associated with applying a discount rate to the lease payments.

DO7 Mr Zhang believes that the recognition exemption has the potential to set an inappropriate precedent by implying that the materiality guidance in IFRS is insufficient to capture contracts for which the costs of applying IFRS outweigh the benefits. Mr Zhang believes that a similar argument could be used to justify many other exemptions from applying the requirements in IFRS.

DO8 Mr Zhang also notes that the recognition exemption for leases of low-value assets could create the same tension between leasing and buying low-value assets that existed applying the requirements of IAS 17. Mr Zhang is concerned that entities that require material amounts of low-value assets would be incentivised to lease those assets rather than buy them in order to achieve off balance sheet accounting.

DO9 Finally, Mr Zhang is concerned about the operationality of determining whether an asset is of 'low value'. Mr Zhang notes that paragraph BC100 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.' Mr Zhang does not think that this reference to US$5,000 is appropriate. He notes that the same asset, when new, can have a different value in different markets, and that the value of a particular asset, when new, can change over time. Moreover, many countries or regions use different currencies, and exchange rates for those currencies change over time. Mr Zhang acknowledges that the exemption is optional and, thus, that entities are not required to apply the exemption. Nonetheless, Mr Zhang is of the view that stating a quantitative amount based on a particular currency may cause difficulties in applying the exemption among entities in different jurisdictions over time.

Appendix
Amendments to the Basis for Conclusions on other Standards

This appendix describes the amendments to the Basis for Conclusions on other Standards that the IASB made when it finalised IFRS 16.

Amended paragraphs are shown with deleted text struck through and new text underlined.

IAS 40 *Investment Property*

In the Basis for Conclusions, paragraph BC10A and its related heading are added.

IFRS 16 *Leases*

BC10A IFRS 16 *Leases* amended the scope of IAS 40 by defining investment property to include both owned investment property and investment property held by a lessee as a right-of-use asset. A summary of the IASB's considerations in developing the amendments to the scope of IAS 40 are set out in paragraphs BC178–BC181 of IFRS 16.

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