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IFRS 16 Lease Modifications

An Overview

IFRS 16 is an international financial reporting standard that provides insights on accounting for leases. Issued in January 2016, the standard is effective for all of the entities that report under IFRS.

IFRS 16 defines how an IFRS reporter will identify, measure, present and disclose leases. The standard provides a single lessee accounting model, which requires lessees to identify assets and liabilities for all leases. Exceptions apply for cases wherein the lease term is 12 months or less or the underlying asset has a less value.

What is lease modification in IFRS 16?

When modifications that were not part of the original terms and conditions of the lease are made, it is termed as lease modification. Common lease modifications include, for example:

Underlying Assets:
- Adding the right to use one or more underlying assets.
- Removing the right to use one or more underlying assets.

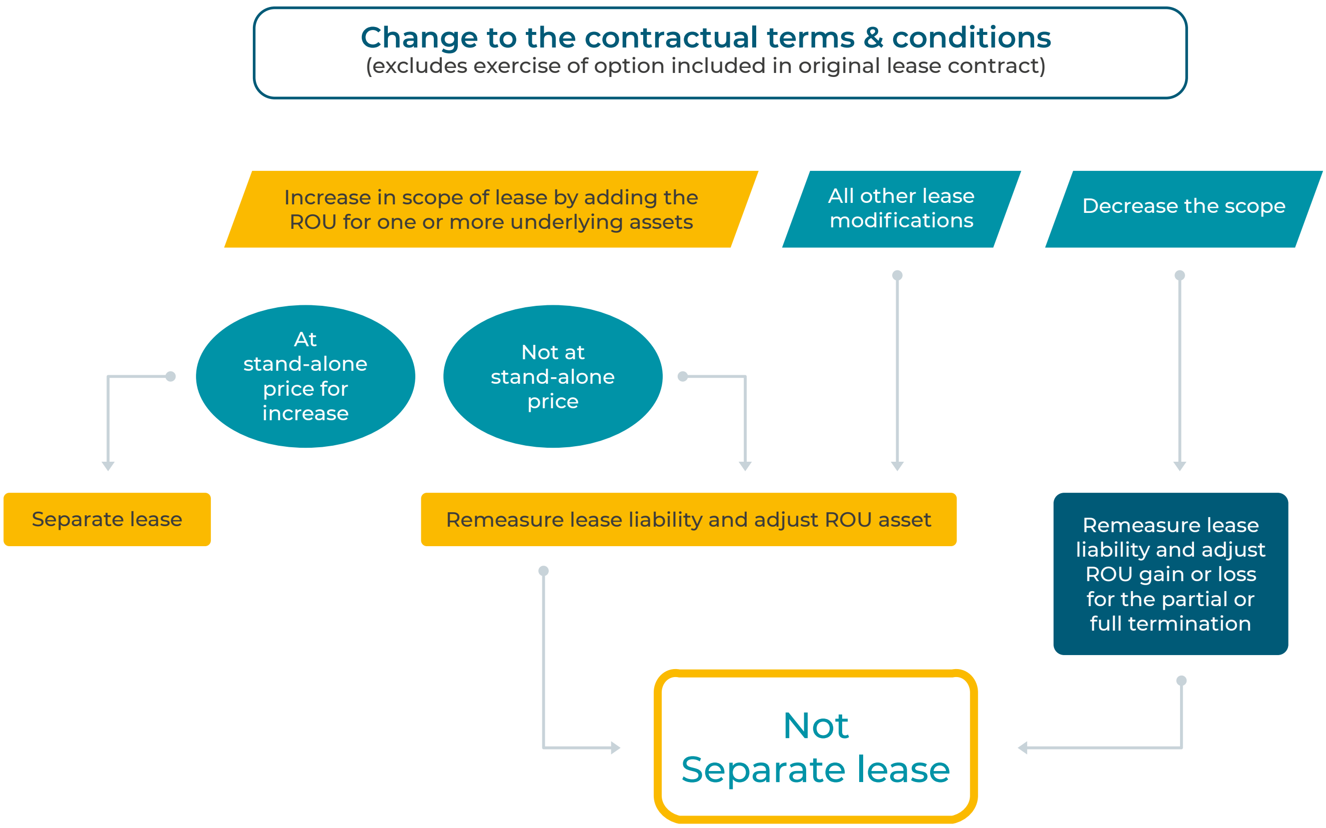
Lease Term:
- Reducing the lease term.
- Extending the lease term.

Lease Consideration:
- Changing the consideration in the lease by increasing or decreasing the lease payments.
- Modifications can occur in any of the above situations or all.

What is Lease reassessment in IFRS 16?

Lease Reassessment is reassessment of estimates used in lease accounting. Common lease reassessments include;
- Assessment of the lease term.
- Assessment of whether a purchase option will be exercised.
- Expected amount payable under a residual value guarantee.
- Future lease payments from a change in the index or rates used to determine those payments;
- Lease payments resulting from a change in floating interest rates; or
- Variable lease payments becoming fixed or in-substance fixed payments.

How are changes to contractual terms and conditions accounted in IFRS 16?



Types of Lease modificatioon	Accounting
Decrease in scope and change in consideration	**1.**Decrease the lease liability and ROU in proportion to the decrease in scope. Recognize a gain or loss for the difference between the change in the lease liability and change in the ROU. **2.**Remeasure the lease liability with the modified terms, using a revised discount rate. Adjust ROU with the corresponding change in lease liability.
All other modifications	Remeasure the lease liability to adjust the modified terms using a revised discount rate. Adjust ROU with the corresponding change in lease liability.

How are Discount Rates accounted in IFRS 16?

Lease Modification accounted as a separate lease:
Lessee does not revise the discount rate used in the original lease. New discount rate used for the separate lease.

Lease Modification not accounted as a separate lease:
Remeasures lease liability with revised discount rate.

Increase in scope not at stand-alone price in IFRS 16

Here, a lessee accounts for a lease modification that leads to an increase in the scope by adding the right to use one or more underlying assets. But the consideration for this is not at a stand-alone price as given below:

- Allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and in the case of non-lease components, the aggregate price is considered
- Decide on the term of the lease
- Remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and
- Make a corresponding adjustment to the right -of-use asset

Example

Lessee A entered into a lease contract with Lessor B to lease one shop for 5 years. At the beginning of Year 3, A and B amend the contract for additional shop space in the same building for four years. The new shop space is the same size as the original shop space and similar in all significant respects. B has given a discount of 20% for the new space which are below the market rate for such a similar space.

Modification increased the scope by adding additional underlying asset but the increase in the lease amount is not commensurate with the standalone price for increase in the space. There, this modification is not a accounted for as a separate lease. At the effective lease modification date, A remeasures the lease liability by discounting the revised lease payments with the revised discount rates and make a corresponding adjustment in ROU.

Decrease in scope

A lessee accounts for decreases in scope – i.e. it is no longer possible to use one or more underlying assets or the contractual lease term is lessened– as follows:

- Allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and in the case of non-lease components, the aggregate price is considered
- Decide on the term of the lease
- Remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and
- Reduce the pre-modification right-of-use asset along with the pre-modification lease liability and recognize any gain or loss in profit or loss to reflect partial or full termination; and
- Make alterations to the remaining right-of-use asset for the difference between the remaining lease liability and modified lease liability

Example

Lessee A entered into an 8-year lease for 5,000m2 office space with Lessor B. The rental payments are AED 100,000 per annum payable in arrears. The incremental borrowing rate at commencement of the lease is 6% (assume that the interest rate implicit in the lease cannot be readily determined).
Subsequently at the beginning of Year 5, A and B amends the contract to reduce the space to 3000m2 (i.e. a reduction of 2,000m2) with a reduced lease payment of AED 70,000 per annum, payable in arrears for the remaining four years. The incremental borrowing rate at this date is 7%. (assume that the interest rate implicit in the lease cannot be readily determined).

The decreases in scope (office space) and consideration were not included in the original terms and conditions of the lease. Therefore, this is a lease modification.

At the beginning of Year 5 (the effective date of the modification)there are two elements to be accounted for:

- As a first step, A accounts for the partial termination of the lease (reduction of 2,000m2) by reducing the carrying amount of the right-of-use asset and lease liability and recognising any resulting gain or loss in profit or loss account
- As a second step, A remeasures the lease liability by discounting the revised lease payments with the revised discount rates and make a corresponding adjustment in ROU.

Increase in lease term in IFRS 16

A lessee accounts for a modification that is an increase in the lease term as given below:

- Allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and in the case of non-lease components, the aggregate price is considered
- Decide on the term of the lease
- Remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and
- Make a corresponding adjustment to the right-of-use asset

Example

Lessee A enters into a 10-year lease of a machinery with Lessor B with no renewal/termination options. A does not provide any residual value guarantee. The annual lease payments are 50,000 payable in arrears. At the end of Year 8 A and B agree to extend the lease term by an additional 5 years – i.e. the lease term will be 15 years in total. The annual lease payments remain unchanged and there are no amendments in the other clauses as a result of the modification.

Because there were no renewal options in the original lease, this is not a reassessment of the lease term. This is a lease modification that increases the lease term only – i.e. it does not grant A the right to use an additional underlying asset. Therefore, it cannot be accounted for as a separate lease. Thus A recognizes the difference between the carrying amount of the lease liability before the modification and the carrying amount of the modified lease liability as an adjustment to the right-of-use asset.

Change in consideration only

A lessee accounts for a lease modification that is a change in consideration as stated below:

- Allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and in the case of non-lease components, the aggregate price is considered.
- Decide on the term of the lease
- Remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and
- Make a corresponding adjustment to the right-of-use asset

Example

Lessee A enters into a 20-year lease of office space with Lessor B. The annual lease payments are AED 100,000 payable in arrears. At the end of Year 10, A and B agree to reduce the lease payments to AED 80,000 payable in arrears.

The change in consideration was not part of the original terms and conditions of the lease and is therefore a lease modification. The modification does not grant A an additional right of use and therefore cannot be accounted for as a separate lease. At the effective lease modification date, A remeasures the lease liability by discounting the revised lease payments with the revised discount rates and makes a corresponding adjustment in ROU.

The new standard provides detailed information on the lessor accounting for lease modifications. An entity adopting IFRS 16 are required to address historical lease modifications as part of its transition project. Also, all organizations must prepare for lease modifications that will take place after transition.