Applying IFRS

IASB issues a new leases standard – tank terminals

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Contents

What you need to know

- The IASB has issued a new leases standard that requires lessees to recognise most leases on their balance sheets. For lessees of tank terminal storage facilities, this means recognising assets and liabilities for most leases of property, plant and equipment, such as storage tanks, that they may currently account for as operating leases.
- Lessees will apply a single accounting model for all leases (with certain exemptions).
- Lessor accounting is substantially unchanged and the IAS 17 *Leases* classification principle has been carried over to IFRS 16 *Leases*.
- Tank terminal entities and tank terminal customers may need to exercise judgement to determine whether a contract is or contains a lease.
- Tank terminal customers will be affected, not only because of the impact on their financial statements, but also on their systems and processes and how they negotiate with suppliers.
- The new standard is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.

Overview

IFRS 16 could have far reaching implications for tank terminal customers. The impacts go beyond accounting, to commercial decision making and strategic financial decisions.

The tank terminal industry will need to change certain lease accounting practices when implementing IFRS 16 *Leases*, the new leases standard issued by the International Accounting Standards Board (IASB). IFRS 16 significantly changes the accounting for leases by lessees and could have far-reaching implications for the finances and operations of users of tank terminal storage facilities. For example, the impact on tank terminal customers' financial reporting, financial ratios and metrics, asset financing, IT systems, processes and controls could be substantial. This may cause tank terminal customers to consider how they contract with tank terminal entities. Accordingly, this publication considers the impacts of IFRS 16 on tank terminal entities and tank terminal customers.

IFRS 16 requires lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. Lessees apply a single model for most leases. Generally, the profit or loss recognition pattern will change as interest and depreciation expense is recognised separately in the statement of profit or loss (similar to today's finance lease accounting). However, lessees can make accounting policy elections to apply accounting similar to operating lease accounting in IAS 17 *Leases* to short-term leases and leases of low-value assets.

Lessor accounting is substantially unchanged from current accounting. As with IAS 17, IFRS 16 requires lessors to classify their leases into two types: finance and operating leases. Lease classification determines how and when a lessor recognises lease revenue and what assets a lessor records.

For tank terminal lessees, recognising lease-related assets and liabilities could have significant financial reporting and business implications. IFRS 16 could influence leasing decisions and strategies (e.g., a tank terminal customer may consider shorter lease terms to minimise lease liabilities). Additionally, lessees' debt covenants and borrowing capacity may be affected, which could also impact their decisions on how they will contract for the use of storage tanks or pipelines. The way in which tank terminal customers respond to the financial reporting and business implications of the new leases standard may have significant consequential impacts for tank terminal entities.

In addition, because the current accounting for operating leases and service contracts is similar, entities may not have focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under IAS 17 and IFRIC 4 *Determining whether an Arrangement contains a Lease* because, under IFRS 16, most leases are recognised on lessees' balance sheets, and the effects of treating an arrangement as a service instead of an arrangement containing a lease may be material. Implementing the standard could require an entity to develop new processes and controls to track and account for leases, including: (1) identifying a lease; (2) initially and subsequently measuring lease-related assets and liabilities; (3) identifying and allocating consideration to the lease and non-lease components; and (4) collecting and aggregating information necessary for disclosure.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided that the new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, has been or is applied at the same date as IFRS 16. Lessees must apply IFRS 16 using either a full retrospective or a modified retrospective approach.

This publication summarises the new standard and describes some sector-specific issues that tank terminal entities and their customers may wish to consider. Like all other entities, they will also need to apply the new standard to leases of office space, office equipment and all other assets within the scope of IFRS 16.

Our *Applying IFRS*: *A closer look at the new leases standard* (EYG no. 02173-163Gbl), issued in August 2016, provides an in depth discussion of the requirements of IFRS 16. We refer to that publication as our *General Applying IFRS*. Please refer to it for further information about the technical accounting topics and concepts discussed here. In addition, our *IFRS Practical Matters*, *Leases make their way onto the balance sheet: Navigating the journey for a smooth landing* (EYG No. AU3725), is designed to help entities to understand the business impacts of the new standard. Please refer to it for further information about the impacts of the standard and the steps entities should be taking to apply it. This publication summarises the key implications for tank terminal entities and tank terminal customers.

The views we express in this publication are preliminary as of February 2017. We may identify additional issues as we analyse IFRS 16 and entities begin to interpret it, and our views may evolve during that process.

1. Key considerations

1.1 Scope and scope exclusions

IFRS 16 applies to leases of all assets, except for the following:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources
- Leases of biological assets held by a lessee
- Service concession arrangements
- Licences of intellectual property granted by a lessor
- Rights held by a lessee under certain licensing agreements (e.g., motion picture films, patents and copyrights)

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described above.

1.2 Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

To be a lease, a contract must meet both of the following criteria:

- It must depend on the use of an identified asset; and
- It must convey the right to control the use of the identified asset.

Storage arrangements entered into by tank terminal entities and customers may provide a right on behalf of the customers to control the use of an identified asset(s).

While not specific to the tank terminal entities, there are many other arrangements commonly entered into that will also need to be considered. These include outsourcing arrangements, such as IT, and utility supply arrangements, such as those for the purchase of gas, electricity, water or telecommunications. These arrangements will require both tank terminal entities and their customers to consider the potential impacts of IFRS 16.

Entities will need to carefully evaluate, at inception of the contract, whether the supplier's substitution rights, if any, are substantive.

1.2.1 Identified asset

The concept of an identified asset is generally consistent with the 'specified asset' concept in IFRIC 4. Under IFRS 16, an identified asset can be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset.

Even if an asset is specified, a customer does not have the right to use an identified asset if, at the inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from exercising its right to substitute the asset. For example, if the tank terminal entity has a total capacity of 500,000 litres, with a single 100,000 litre capacity tank capable of storing fuel with 95 octane at the required temperature and location (i.e., the asset is highly customised to the product), and the customer requires 100,000 litres of storage capacity for that specific product, the tank terminal entity's substitution right may not be substantive.

Likewise, if additional tanks could be made available to meet the specific storage requirements, the tank terminal entity and its customer would need to assess whether the subtitution right is substantive or not. For example, the tank terminal entity may have the practical ability to substitute alternative tanks throughout the period of use. However, to the extent that the costs of cleaning the additional tanks to prevent product contamination are prohibitive, the tank terminal entity would be unable to benefit economically from exercising its substitution right.

If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes that any substitution right is not substantive.

1.2.1.1 Identified asset as a physically distinct portion of a larger asset

An identified asset can be a physically distinct portion of a larger asset. An example includes a floor of a building. However, a capacity portion or other portion of an asset that is not physically distinct (e.g., a capacity portion of a tank) is not an identified asset unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Illustration 1 — Identified asset - capacity portion of an asset

Customer X enters into a five-year contract with Supplier Y for the right to store oil at Supplier Y's terminal. The contract provides that Customer X will have the right to the use of 95% of a specified tank's capacity throughout the term of the arrangement. Assume that there are no substantive substitution rights.

Analysis: The capacity portion of the tank is an identified asset. While 95% of the tank's capacity is not physically distinct from the remaining capacity, it represents substantially all of the capacity of the specified tank and thereby provides Customer X with the right to obtain substantially all of the economic benefits from use of the tank.

In some cases, determining whether there is an identified asset can be relatively straightforward. However, in other cases this assessment may require judgement.

1.2.2 Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding, or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through its use), including potential cash flows derived from these items. Economic benefits also include those from using the asset that could be realised from a commercial transaction with a third party. However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset.

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

(a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use

Or

(b) The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either:

i. Has the right to operate the asset, or direct others to operate the asset in a manner that it determines, throughout the period of use, without the supplier having the right to change those operating instructions

Or

ii. Designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus is on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also states that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

When an agreement involves an identified asset, tank terminal entities and customers will need to evaluate which party has the right to control the use of the asset. IFRS 16 provides examples of the decision-making rights that, depending on the circumstances, provide the customer with the ability to direct how and for what purpose the asset is used, within the defined scope of the customer's right of use.

For example, determining whether conditions are safe for operation is likely to be the right and responsibility of the tank terminal entity. These rights may be considered protective rights, which, in isolation, are not the decisions that most significantly affect the economic benefits derived from the tanks and associated equipment throughout the period of use.The tank terminal customer may be considered to have the right to direct the use of the identified asset i.e., by determining the type and quantity of the product stored and when and how much the product will go into and out of the tank. Alternatively, other circumstances may indicate that the right to direct how and for what purpose the asset is used is retained by the tank terminal entity. This evaluation will require entities to consider a range of facts and circumstances regarding the use of the assets and will require entities to apply judgement.

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

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

For contracts that contain the rights to use multiple assets (e.g., a tank and associated loading and unloading equipment), the right to use each asset is considered a separate lease component if both of the following conditions are met: (1) the lessee can benefit from the use of the underlying asset, either on its own or together with other resources that are readily available to the lessee; and (2) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the lease contract for an office building (for head office premises) and an adjacent land parcel to be used for future development by the lessee (of a new tank terminal) will generally be considered to contain two lease components because the lessee could benefit from the office building without development of the adjacent land parcel.

Tank terminal customers may control the use of more than one tank in a terminal. Thus, it is necessary to assess whether the arrangement constitutes a single, or multiple, lease components (e.g., each tank as a lease component) based on the criteria discussed above. In addition, at storage terminals, there is significant ancillary equipment used, such as the loading and unloading bays, manifolds and interconnected pipelines. This increases the complexity of assessing whether such ancillary equipment is an identified asset and, if so, whether the right to use such equipment represents a separate lease component. The assessment of what constitutes "highly interrelated" or "highly dependent" depends on specific facts and circumstances and requires judgement.

Many contracts contain a lease coupled with an agreement to purchase or sell or use other goods or services (non-lease components). For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other standards. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 by lessors (suppliers).

Contracts between tank terminal entities and customers may contain significant non-lease components. For example, the tank terminal entity may provide a range of services such as berthing, unloading and transportation via manifold and pipeline to the storage tank. Entities will have to assess which of these components constitutes the provision of a service and which constitutes the lease of equipment.

IFRS 16 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component. This will require tank terminal customers to consider the trade-off between effort required to account for lease and non-lease components separately, and the impact of grossing up the balance sheet by the greater amount if non-lease components are not separated.

Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Lessees are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees estimate stand-alone prices, maximising the use of observable information.

Lessors do not have a practical expedient to account for lease and non-lease components as a single lease component. Lessors are required to apply IFRS 15 to allocate the consideration in a contract between the lease and non-lease components generally on a relative stand-alone selling price basis. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the lessor must estimate the stand-alone selling price. IFRS 15 provides suitable methods for doing this.

How we see it

Identifying non-lease components of contracts (e.g., berthing and unloading services provided with a storage arrangement that is treated as a lease) may change practice for tank terminal entities and tank terminal customers. For example, today, lessees may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases are recognised on lessees' balance sheets under IFRS 16, lessees may need to implement more robust processes in place to identify the lease and non-lease components.

2. Lease classification

Under IFRS 16, lessors classify all leases in the same manner as under IAS 17, distinguishing between two types of leases: finance and operating. Lessors are required to reassess lease classification upon a modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease) that does not result in a separate lease.

Lessees, however, apply a single accounting model for all leases, with options not to recognise short-term leases and leases of low-value assets on the balance sheet. See sections **3.1 Short-term leases recognition exemption** and **3.2 Leases of low-value assets recognition exemption** for discussion of these exemptions.

3. Lessee accounting

At the commencement date of a lease, a lessee recognises a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

Lessees measure the lease liability using the interest rate implicit in the lease, if that rate is readily determinable. If that rate cannot be readily determined, the lessee is required to use its incremental borrowing rate. Lessees measure the right-of-use asset at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Lessees are required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset. When the right-of-use asset is depreciated on a straight-line basis, this will generally result in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of finance leases under IAS 17.

Appendix A sets out an example of lessee accounting.

3.1 Short-term leases recognition exemption

Lessees can make an accounting policy election, by class of underlying asset to which the right of use relates, to apply accounting similar to IAS 17's operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset (short-term leases). If a lessee applies this exemption, short-term leases are not recognised on the balance sheet and the related lease expense is recognised on a straight-line basis over the term of the lease or another systematic basis, if that basis is more representative of the pattern in which the benefits from the use of the underlying asset are diminished. In deciding whether to apply the short-term lease exemption, entities will need to consider the lease term, i.e., the non-cancellable period of the lease together with any periods covered by an option to extend the lease, if an option for extension exists and the lessee is reasonably certain to exercise that option. A lease that contains a purchase option is not a short-term lease.

3.2 Leases of low-value assets recognition exemption

Lessees can also make an election, on a lease-by-lease basis, to apply accounting similar to current operating lease accounting to leases for which the underlying asset is of low value (low-value assets). To be a low-value asset, a lessee must be able to benefit from the asset either on its own or together with other resources that are readily available to the lessee. In addition, a low-value asset must not be highly dependent on, or highly interrelated with, other assets. At the time of reaching its decisions about the exemption, the IASB had in mind leases of underlying assets with a value, when new, of US$5,000 or less. It is unlikely that the low value asset recognition exemption would apply to tank terminal contracts, but it may apply to other contracts such as lease of office equipment.

How we see it

The requirement that lessees recognise assets and liabilities for most leases will impact both their balance sheets and statements of profit or loss. Lessees' debt and equity ratios are likely to be affected by the gross-up of their balance sheets. Operating lease expense under IAS 17 is replaced by depreciation and interest expense. This will not only affect some performance measures, such as EBIT or EBITDA that are key performance measures for almost all tank terminal customers, but may also affect other performance measures, such as interest cover, depending on the characteristics of the lease portfolio and the effects on the expense recognition pattern.

This could influence the leasing strategies of tank terminal customers. For example, some lessees may seek to negotiate lease terms with fewer years than they do currently in order to reduce the balances of recorded assets and liabilities. Others may consider further changes to their negotiated terms which may minimise the use of arrangements that meet the definition of a lease, but also result in less control over the assets required to meet its commercial objective. Many factors will influence a lessee's decisions, including the nature of its business, its business requirements, debt and equity covenant restrictions and access to capital.

4. Lessor accounting

Tank terminal entities will have to consider whether the contractual arrangements with tank terminal customers provide the tank terminal customer the right to use a specific asset or a portion of its tank terminal assets (discussed above).

IFRS 16 requires lessors to account for operating leases using an approach that is substantially unchanged from IAS 17. That is, lessors continue to recognise the underlying asset and lease payments are recognised as income over the lease term, either on a straight-line basis or another systematic basis that is more representative of the pattern in which the benefits from the use of the underlying asset is diminished.

Under IFRS 16, lessors are required to account for finance leases also using an approach that is substantially unchanged from IAS 17. That is, lessors derecognise the carrying amount of the underlying asset, recognise a lease receivable[1] and recognise, in profit or loss, any selling profit or loss.

5. Other considerations

5.1 Arrangements entered into by tank terminal customers that are joint arrangements

Tank terminal customers often enter into joint arrangements and these are effected by a joint operating agreement with other entities.

A contract for the use of an asset by a joint arrangement might be entered into in a number of different ways, including:

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

- Directly by the joint arrangement, if the joint arrangement has its own legal identity
- By each of the parties to the joint arrangement (i.e., the operator and the other parties, commonly referred to as the non-operators) individually signing the same arrangement
- By one or more of the parties to the joint arrangement on behalf of the joint arrangement. Generally, this would be evidenced in the contract and the parties to the joint arrangement would have similar rights and obligations as they would if they individually signed the arrangement. In these situations, the facts and circumstances, as well as the legal position of each entity, need to be evaluated carefully.
- By the operator of the joint arrangement in its own name, i.e., as principal. This may occur where the operator leases equipment which it then uses in fulfilling its obligations as operator of the joint arrangement and/or across a range of unrelated activities, including other joint arrangements with unrelated activities, such as with other joint operating parties.

IFRS 16 states that where a contract has been entered into by a joint arrangement, or on behalf of the joint arrangement, the joint arrangement is considered to be the customer in the contract.[2] Accordingly, in determining whether such a contract contains a lease, an assessment needs to be made as to which party (e.g., the joint arrangement or the operator) has the right to control the use of an identified asset throughout the period of use.

If the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use as a result of their collective control of the operation, the joint arrangement is the customer to the contract that may contain a lease. It would be inappropriate to conclude that the contract does not contain a lease on the grounds that each of the parties to the joint arrangement either has rights to a non-physically distinct portion of an underlying asset and, therefore, obtains only a portion of the economic benefits from the use of that underlying asset or does not unilaterally direct its use. Determining if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use would require a careful analysis of the rights and obligations of each party.

In the first three scenarios above, if it has been determined that a contract is, or contains, a lease, where the joint arrangement was classified as a joint operation, each of the parties to the joint arrangement (i.e., the joint operators comprising the operator and the non-operators) will account for their respective interests in the joint arrangement (including any leases) under paragraphs 20-23 of IFRS 11 *Joint Arrangements*. Therefore, they will account for their individual share of any right-of-use assets and lease liabilities, and associated depreciation and interest.

In the final scenario (i.e., where the operator enters the arrangement in its own name), the operator will need to assess whether the arrangement is, or contains, a lease. If the operator controls the use of the identified asset, it would recognise the entire right-of-use asset and lease liability on its balance sheet. This would be the case even if it is entitled to bill the non-operator parties for their proportionate share of the costs under the joint operating agreement.

[2] IFRS 16.B11

If the operator determines it is the lessee, it would also evaluate whether it has entered into a sublease with the joint arrangement (as the customer to the sublease). For example, the operator may enter into a five-year equipment lease with a supplier, but may then enter into a two-year arrangement with one of its joint arrangements, thereby yielding control of the right to use the equipment to the joint arrangement during the two-year period. The conclusion as to whether the joint arrangement is a customer, i.e., the lessee in a contract with an operator, by virtue of the joint operating agreement, would be impacted by the individual facts and circumstances.

If there is a sublease with the operator, the non-operators would recognise their respective share of the joint operation's lease right-of-use asset and lease liablity and the operator would have to account for its sublease to the joint arrangement separately. However, if no sublease existed, the non-operators would recognise joint interest payables when incurred for their share of the costs incurred by the operator in respect of the leased asset.

Depending on the conclusions reached, an operator may observe differences in the recognition patterns in profit or loss between the head lease costs (which will have more of a front-loaded expense profile) and the income received from billing the non-operators (either through a sublease or joint interest billings).

How we see it

- Evaluating the requirements of IFRS 11 and IFRS 16 for joint arrangements will involve judgement and consideration of the legal implications of the contractual arrangements in place. As entities continue to evaluate the impact of such requirements, interpretations may evolve.
- Entities may also need to exercise judgement in determining how to disclose information about leases that will be meaningful to financial statement users, particularly when they are operators of some leased assets and non-operators of other assets, for which they may recognise their share of a sublease and/or recognise joint interest payables for activities performed by the operator using leased assets.

5.2 Variable lease payments

Variable lease payments that depend on an index or rate are included in lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). Variable payments that do not depend on an index or rate, such as those based on performance or usage of the underlying asset, are not included as lease payments.

Variable payments that are not based on an index or rate and are not in-substance fixed lease payments are recognised in a manner similar to today's accounting. Lessees recognise an expense in the period in which the event that triggers those payments occurs. Although IFRS 16 does not specify the lessor's accounting for variable lease payments that do not depend on an index or rate, given that the IASB decided to substantially carry forward the lessor accounting model in IAS 17, a lessor recognises such variable lease payments as income in the period in which they are earned, consistent with current accounting.

Under IFRS 16, lessees are required to remeasure the lease liability under certain circumstances, including when there is a change in future lease payments resulting from a change in an index or rate used to determine those payments. The lessee is required to remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (i.e., when the adjustment to the lease payment takes effect). For example, lease payments are often linked to the annual change in the Consumer Price Index (CPI); lessees with such clauses in their leases remeasure their lease liability whenever a change in CPI triggers a change in the contractual lease payments.

Absent a lease modification, lessors do not remeasure the lease receivable for variable lease payments that depend on an index or rate. However, for lessors that provide periodic calculations, this may lead to an increase in administration of contracts to provide lessees with the level of information required to apply IFRS 16.

5.3 Lease modifications

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

IFRS 16 defines a lease modification as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (e.g., adding or terminating the right to use one or more underlying assets, extending or shortening the contractual lease term).

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

- The modification increases the scope of the lease by adding the right to use one or more underlying assets (e.g., the use of an additional tank) not included in the original lease
- The consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract

If both of these conditions are met, the lease modification results in two separate leases: the unmodified original lease and the new lease. For example, a tank terminal entity may have entered into a contract with a customer to lease one 50,000 litre storage tank for 24 months. Six months later, the tank terminal customer may determine that, due to an increase in inventories, it requires an additional 50,000 litre storage tank for the remaining 18 months of the contract. If the additional storage tank is leased for 18 months at an amount commensurate with the stand-alone price for that leased asset, this would be considered to be a new lease, and for the remaining 18-month period, two lease arrangements will exist.

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

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

- If the lease would have been classified as an operating lease, had the modification been in effect at the inception date, the modification is treated as a new lease from the effective date of the modification. The lessor measures the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.

- If the lease classification does not change as a result of the modification, the modification is accounted for in accordance with IFRS 9 *Financial Instruments*.

Lessors account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

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

5.4 Sale and leaseback transactions

Sale and leaseback transactions will no longer provide seller-lessees with a source of off-balance sheet financing.

Because lessees are required to recognise most leases on the balance sheet (i.e., all leases except for short-term leases and leases of low-value assets if the lessee makes accounting policy elections to use those exemptions), sale and leaseback transactions will no longer provide lessees with a source of off-balance sheet financing.

IFRS 16 requires seller-lessees and buyer-lessors to apply the requirements of IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

How we see it

The new requirements are a significant change from current practice for seller-lessees. Under IFRS 16, seller-lessees must apply the requirements in IFRS 15 to determine whether a sale has occurred. Also, even if the criteria for a sale have been met, sale and leaseback transactions, generally, would no longer lead to an off-balance sheet financing.

5.5 Effective date and transition

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

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

Next steps

- Entities should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected by the application of IFRS 16. Two critical first steps include: (1) identifying the sources and locations of the entity's lease data; and (2) accumulating the data in a way that will facilitate the application of IFRS 16. For entities with decentralised operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility for differences in operational, economic and legal environments.
- Entities will need to make sure they have the processes, including internal controls, and systems in place to collect the necessary information to implement IFRS 16 (including making the necessary financial statement disclosures).
- Evaluating the effects of IFRS 16 and implementing it could require significant effort given the number of contracts that are potentially in scope.
- Timely assessment and management of the impact on financial ratios, IT systems, processes, controls and resource requirements will help entities control the effect on their business. For example, tank terminal customers should start discussing the effect on covenants and financing agreements with lenders, rating agencies and other users of the entity's financial data.
- Tank terminal entities and tank terminal customers should begin to educate their commercial departments about IFRS 16 and encourage them to start evaluating their portfolios of current contracts and prospective contracts to identify which lessees may seek to alter their leasing strategies as a result of IFRS 16.

Appendix A: Lessee accounting example

Illustration 2 — Lessee accounting

Best Petroleum Inc. (lessee) enters into a three-year contract with Tank Terminals Plc (lessor) for the right to use three specified tanks at a terminal and storage facility in Singapore. Best Petroleum Inc. agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. For simplicity, there are no lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of 4.235%). Best Petroleum Inc. uses its incremental borrowing rate as the discount rate because the rate implicit in the lease cannot be readily determined. Best Petroleum Inc. depreciates the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Best Petroleum Inc. recognises the right-of-use asset and lease liability in a manner similar to what it would do today under a finance lease:

Right-of-use asset	CU33,000	
Lease liability		CU33,000

To initially recognise the lease-related asset and liability

The following journal entries would be recorded in the first year:

Interest expense	CU1,398	
Lease liability		CU1,398

To record interest expense and accrete the lease liability using the interest method (CU33,000 x 4.235%)

Depreciation expense	CU11,000	
Right-of-use asset		CU11,000

To record depreciation expense on the right-of-use asset (CU33,000 ÷ 3 years)

Lease liability	CU10,000	
Cash		CU10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is, as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		CU10,000	CU12,000	CU14,000
Lease expense recognised				
Interest expense		CU1,398	CU1,033	CU569
Depreciation expense		11,000	11,000	11,000
Total periodic expense		CU12,398	CU12,033	CU11,569
Balance sheet				
Right-of-use asset	CU33,000	CU22,000	CU11,000	CU–
Lease liability	CU(33,000)	CU(24,398)	CU(13,431)	CU–

Immaterial differences may rise in the computation of amounts in the example above due to rounding.

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