IFRS 16: Fixed Payments and Variable Lease Payments

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A lessee is required to initially measure the lease liability at the present value of the lease payments. Paragraph 27 of IFRS 16 *Leases* indicates the type of lease payments included in the measurement of the lease liability:

(a) fixed payments (including in-substance fixed payments) less any lease incentives receivable;

(b) variable lease payments that depend on an index or a rate;

(c) amounts expected to be payable by the lessee under residual value guarantees;

(d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

(e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Paragraph B42 of IFRS 16 describes in-substance fixed lease payments as "payments that may, in form, contain variability but that, in substance, are unavoidable." Examples include:

(a) Payments structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance.

(b) There is more than one set of payments the lessee could make, but only one set of payments is realistic. In this case, the realistic set of payments is considered to be lease payments.

(c) There is more than one realistic set of payments the lessee could make, but it must make at least one of those sets of payments. In this case, the set of payments that aggregates to the lowest amount (on a discounted basis) is considered to be lease payments.

Variable lease payments that are linked to the future performance or use of the underlying asset are excluded from the measurement of the lease liability.

The Group discussed three fact patterns to highlight some of the principles and application guidance in IFRS 16 to determine which lease payments should be included or excluded from the initial measurement of the lease liability.

Fact Pattern 1

- An entity has a mine that is starting commercial production. The entity enters into a contract to lease substantially all of its critical mining and milling equipment. The lease has a term of 20 years, which is the estimated life of the mine.

- Lease payments are determined based on realized mineral extraction at a rate of $50 per unit of mineral product. There is no minimum payment. Based on the entity's mine plan, it expects that realized mineral extraction will be at least 100,000 units per annum.
- Assume the entity has determined that the contract contains a lease and that there are no non-lease elements to the contract.

Issue 1: Is the following analysis appropriate in determining the lease payments that should be excluded from the initial measurement of the lease liability?

Analysis

Although the entity is able to estimate the minimum lease payments it will make over the lease term, the lease payments are solely linked to the usage of the underlying asset. If the entity did not achieve any realized mineral extraction, the minimum amount payable would be nil.

There is genuine variability to the lease payments and the variability will remain throughout the lease term. As a result, the entity will recognize lease payments as an expense in profit or loss when it realizes mineral extraction.

The Group's Discussion

Group members agreed with the above analysis.

Fact Pattern 2

- The facts and circumstances presented in Fact Pattern 1 are the same, except that there is a minimum fixed annual payment of $500,000 rather than a straight variable fee based on realized extraction. In addition, if realized extraction is more than 10,000 units per annum, the annual payment will be increased to $5 million. If realized extraction is more than 125,000 units per annum, the annual payment will be increased to $6 million.
- Based on the entity's mine plan, realized mineral extraction is expected to be at least 100,000 units per annum (i.e., it is very unlikely to be less than 10,000 units per annum). However, it is uncertain whether the realized mineral extraction will be more than 125,000 units per annum.

Issue 2: Which amount should be included in the initial measurement of the lease liability?

View 2A – Annual lease payments included in the lease liability should be $500,000.

Proponents of this view note that lease payments in excess of $500,000 per annum are considered variable lease payments. They should be excluded from the measurement of the lease liability because the payments are linked to the usage and performance of the underlying asset.

As a result, the entity will measure the lease liability based on annual payments of $500,000. The entity will expense additional payments of $4.5 million or $5.5 million in profit or loss in the years in which realized extraction exceeds the prescribed amounts.

View 2B – Annual lease payments included in the lease liability should be $5 million.

Proponents of this view look toward the guidance in paragraph B42(b) of IFRS 16. Although there is more than one set of payments, the entity determines a lease payment of only $500,000 is not realistic and, consequently, this set of payments should not be used in measuring the lease liability.

In addition, since there are more than one realistic set of payments, paragraph B42(c) of IFRS 16 indicates that the entity should consider the set of payments that aggregates to the lowest amount to be lease payments. Therefore, $5 million per annum should be used in measuring the lease liability.

The Group's Discussion

Group members supported View 2A because the lease payments in excess of $500,000 still contain variability as they are solely linked to the usage of the underlying asset.

One Group member noted that although there are limited sets of lease payments under Fact Pattern 2, variability still exists for the lease payments in excess of $500,000. For the in-substance fixed payments guidance to apply, an entity would need to be able to articulate why the two fact patterns are different.

Fact Pattern 3

- The facts and circumstances presented in Fact Pattern 1 are the same, except that rather than a straight variable fee based on realized extraction, the lease payments are structured as follows:
  (a) The initial monthly payments are first set at $300,000.
  (b) The monthly payments will increase to $400,000 once the entity realizes mineral extraction of 120,000 for the previous 12-month period and remain fixed at this amount for the remainder of the lease.
- The lease agreement also requires that the monthly lease payments (either $300,000 or $400,000) increase every year on the basis of the increase in the applicable Consumer Price Index (CPI).
- After 30 months from the commencement date of the lease, the entity achieves realized mineral extraction of 120,000 units for the first time.

Issue 3: Is the following analysis appropriate in determining the initial measurement, and subsequent remeasurement, of the lease liability?

Analysis

Paragraph 27(b) of IFRS 16 requires variable lease payments that depend on an index or rate to be included in the initial measurement of the lease liability. In this example, the monthly payment of $300,000 depends on an index. Therefore, the entity would use the CPI index at the commencement date of the lease (i.e., without factoring in future increases in CPI).

The additional monthly payment of $100,000 also varies depending on the same index, but is initially dependent on the usage or performance of the asset. The variability precludes this monthly amount from being included in the initial measurement of the lease liability.

The variability is resolved at month 30, which is the first time that the prior 12-month realized mineral extraction exceeds 120,000 units. At month 30, the entity will remeasure the lease liability based on a monthly lease payment of $400,000 for the remainder of the lease, adjusted as needed for changes in CPI since the commencement of the lease.

Other subsequent changes to the lease payments as a consequence of changes in the CPI index are reflected as adjustments to the lease liability when the changes have taken effect.

The Group's Discussion

Group members agreed with the analysis that the $300,000 monthly lease payment would be included in the initial measurement of the lease liability. At month 30, the entity would remeasure the lease liability using the increased monthly lease payment of $400,000 because the variability is resolved.

With respect to the CPI index, an entity would remeasure the lease liability only at the point when the lease payments are changed as a consequence of applying the CPI index formula, keeping the discount rate unchanged. The same approach is applied if the lease payments depend on an interest rate such as the London Interbank Offered Rate (LIBOR), except that the entity would use a revised discount rate that reflects the change in the interest rate in accordance with paragraph 43 of IFRS 16.

Overall, the Group's discussion on the three fact patterns raises awareness of the principles in IFRS 16 on fixed and variable lease payments. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).