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by Capital Markets & Accounting Advisory Services

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MFRS 16 guidance on variable lease payments

Applicable MFRS	MFRS 16 *Leases*

Lease payments in a lease agreement could be structured in various ways, for example the payments could be a fixed amount, or the payments could vary over the lease period. Some lease agreements include both a minimum fixed payment and an additional variable payment. Lease payments may vary with movements in inflation or market rents, or payments could be linked to the performance of the asset over the lease period such as sales targets or cost savings achieved.

The new leases standard, MFRS 16: Leases provides guidance on how to account for variable lease payments in a lease agreement. For accounting by lessees, MFRS 16 categorises variable lease payments into two categories, i.e. those that depend on an index or a rate; and those that do not depend on an index or a rate.

Impact on SOFP on commencement date

The MFRS 16 guidance on variable lease payments for lessees differs depending on what causes the variability. The impact to profit or loss is more volatile when lease payments do not depend on an index or a rate as such variable lease payments are directly recognised in profit or loss when the variability occurs.

In contrast, there is less volatility to profit or loss when variable lease payments depend on an index or a rate as the variable payments are included in determining the lease liability at the lease commencement date. The lease liability is initially measured using the index or rate and subsequent adjustments are made only when the lease payment changes. Subsequent changes to lease liability are adjusted against rights-of-use asset instead of directly to profit or loss.

As the accounting implications are very different, it is important for entities to assess what drives the variability of lease payments, particularly whether or not the variability depends on an index or a rate.

Variable lease payments that depend on an index or a rate

Examples	Variable lease payments that depend on an index or a rate include payments linked to a consumer price index, benchmark interest rates (such as LIBOR), or payments that vary to reflect changes in market rental rates.
How are the payments recognised?	The variable lease payments are included as part of the lease liability recognised at the lease commencement date, with a corresponding right-of-use ('RoU') asset recognised. A lease liability is recognised even if the entire lease payment in the agreement is variable. The lease liability is initially measured using the index or rate at the lease commencement date. Subsequent changes in the index or rate are only accounted for when the lease payment changes where lease liability is re-measured with a corresponding adjustment to RoU asset.

Variable lease payments that do not depend on an index or a rate

Examples	Variable lease payments that do not depend on an index or rate include payments linked to a lessee's performance derived from the underlying asset (such as payments of a specified percentage of sales made from retail store), or payments linked to the usage of the underlying asset (such as payments if the lessee exceeds a specified mileage of a leased car).
How are the payments recognised?	The variable lease payments are not included as part of the lease liability at the lease commencement date. There is no lease liability recognised at the lease commencement date if the entire lease payment is variable. Variable lease payments are included in profit or loss when the event or condition that triggers the variability occurs.

Please refer to the illustrations in the following page to understand the implications of variable lease payments in various scenarios.

Illustrations

Scenario 1: lease payments are based on market rate

- Entity A (a lessee) enters into an agreement to lease 50,000 hectares of oil palm plantation land from the lessor
- Lease payment in the first year is RM600,000, which reflects market rent of the land at the commencement date
- Subsequently, at the beginning of every year, the annual lease payments will be adjusted to reflect market rental rates of the land
- The lease term is for 15 years

Explanation

In this scenario, as the lease payments are determined based on the market rental rates of the land, these are variable lease payments that depend on an index or rate. Entity A should recognise a lease liability (for the 15 years) which is measured using the market rent at the commencement date (i.e. RM600,000 * 15 years).

At the beginning of the second year, as the lease payment will change based on the market rent at the beginning of Year 2, Entity A will remeasure the remaining lease liability (for the remaining 14 years) based on the market rent of Year 2.

Scenario 2 - lease payments are based on CPO index

- Entity A (a lessee) enters into an agreement to lease 50,000 hectares of oil palm plantation land from the lessor
- Lease payments are variable based on the average Crude Palm Oil (“CPO”) index for the month multiplied by the land hectarage
- The lease term is for 15 years

Explanation

In this scenario, the land area of 50,000 hectares is fixed in the lease agreement. The variability arises solely from the CPO index, which is an index for crude palm oil. Hence Entity A should apply the guidance relating to variable lease payments based on an index or rate where a lease liability (for 15-year rights of use) is recognised and measured using the average monthly CPO price at the lease commencement date.

Illustrations (continued)

Scenario 3 - lease payments are based on output

- Entity A (a lessee) enters into an agreement to lease 50,000 hectares of oil palm plantation land from the lessor
- Lease payments are variable based on the average CPO index for the month multiplied by FFB produced (i.e. quantity produced by bearer plants)
- There is no minimum output specified in the lease agreement
- The lease term is for 15 years

Explanation

In this scenario, the variability arises from both the CPO index as well as the quantity of output produced. As the lease payments depends on each variable which are not independent of each other, the entire payment is accounted for as variable lease payments that do not depend on an index or rate. The entire variable lease payment is excluded from lease liability and accordingly, there is no lease liability recognised at the lease commencement date (unless it meets the definition of an in-substance fixed lease payment in MFRS 16.B42).

Do you need further information on this topic?	Contact: Sukhsharan Kaur | Assurance Senior Manager from PwC Malaysia CMAAS Email: sukhsharan.kaur.amarjit.singh@pwc.com | Tel: +60 (3) 2173 1081
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