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PIR of IFRS 16 - Detailed description of identified matters

Background Paper

Objective

1 This background paper aims to provide detailed descriptions of identified matters:

(a) **Table 1** includes detailed descriptions of application issues; and

(b) **Table 2** includes detailed descriptions of issues related to interaction of other IFRS Accounting Standard.

2 The prioritisation of issues is provided in Agenda Paper 03-01 provided for this session.

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Appendix 2: Detailed description of identified matters

Table 1 – Detailed descriptions of application issues

#	DESCRIPTION OF THE ISSUE	TYPE OF ISSUE
1	**Determining the discount rate** The current requirements are too theoretical, judgmental, and obtaining data on an ongoing basis could be costly for preparers. There is also diversity in practice in how entities define the methodology to calculate the IBR; this might lead to substantially different discount rates across entities, even for similar contracts. On the other hand, EFRAG observes that such a diversity reflects the different levels of creditworthiness assigned by financial institutions to each entity, thereby increasing comparability between leased and financed assets at the individual entity level.	Application difficulties and lack of consistent application
2	**Determining the lease term** Stakeholders noted that diversity in practice may exist, mainly due to the high level of judgment applied for applying current requirements. Indeed, it may be complex determining the non-cancellable period where extension options or tacit annual renewal options exist. Furthermore, some stakeholders highlighted the risk of structuring opportunities to limit the impact of IFRS 16. In particular, lease contracts with similar economic substance but with different contractual terms might be accounted for considering different lease terms leading to different amounts of right of use of assets and lease liabilities recognised in the financial statements. For example, entering in a contract with indefinite lease term or in a lease contract with definite lease term without renewal option would not be reflected in the same way in the financial statements, despite the fact that the underlying asset is expected to be used in practice for the same period of time. In the latter scenario, the substance of the lease transaction would not properly reflect throughout the period of use of the underlying asset	Application difficulties and lack of consistent application

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3	**Identifying lease contracts** Stakeholders noted some difficulties in applying current requirements, mainly due to their complexity and the information asymmetry existing between lessee and lessor at lease inception, to: • Assess whether the lessee directs the use of the asset, including the transfer of control guidance in IFRS 15 to distinguish between principal or agent (i.e., principal versus agent consideration); • assess whether the lessee obtains 'substantially all economic benefits' arising from the use of the underlying asset. IFRS 16 does not define 'substantially all' which may lead to diversity in practice; and • Assess whether the lessor has substantive substitution rights. This might be complex in those contracts related to the provisions of on-premises hardware servers and of several assets with identical characteristics (e.g., forklifts). Furthermore, preparers noted many difficulties in making a distinction between leases and service contracts, when the letter might include embedded leases. For example, in the automotive industry contracts entered with batteries suppliers where the suppliers ensure the production on demand using very specific production machineries based on the customer specifications might include embedded leases. However, in some cases, the customer does not have all the information about the supplier's production capacity to determine whether such a contract conveys the right to control the use of the underlying asset(s).	Application difficulties and lack of consistent application
4	**Separating lease and non-lease components** In practice, the distinction between lease and a non-lease component may be difficult, especially for renewable energy supply contracts (e.g., Power Purchase Agreement) and in multi-components contract (e.g., provision of an asset plus ancillary services).	Application difficulties and lack of consistent application
5	**Sale and leaseback transaction** Several stakeholders noted that for sale and leaseback transactions it might be difficult to assess: • the transaction's unit of account (e.g., when the seller-lessee leases back only part of the asset sold, such as some floors of a building, or an asset that is substantially but not exactly the same, such as the same asset but of a different colour); and • whether the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale (e.g., when a sale contract includes a call option or when the leaseback including the extension options covers substantially all the remaining useful life of an asset).	Lack of guidance is leading to diversity in practice

<table>
<tr><th>#</th><th>DESCRIPTION OF THE ISSUE</th><th>TYPE OF ISSUE</th></tr>
<tr><td>6</td><td>Determining the lease payments

Stakeholders have called of additional guidance to reduce current diversity in practice and provide more clarity in relation to:

• the distinction between variable and in-substance fixed payments;
• the accounting for some rent concessions granted by the lessor during the first period of a lease contract. In practice, such minor lease payments would correspond to a sort of lessor incentive, for example for leasehold improvements made by the lessee at the inception of the contract. If it is the case, the accounting of such rent concessions would reflect the economic substance of the transaction leading to different accounting impacts in the financial statements, especially in the statement of profit or loss because of the different amounts of right of use asset and lease liability recognised at inception date; and
• the accounting for variable lease payments linked to an index when the updated index is not promptly available but has to be applied retrospectively. Lack of clarity on how to account for such adjustments to previous payments.

Furthermore, especially preparers operating in the retail industry, raised concerns about current accounting treatment provided for variable lease payments excluded from the initial calculation of the lease liability. They noted that the relevance of such payments has been increasing in the recent years and therefore a much more relevant part of their leases is still off-balance sheet. Therefore, they questioned whether IFRS 16 achieved its objective. In addition, some stakeholders noted that the accounting for variable lease payments in IFRS 16 is not consistent with that provided for other IFRS Accounting Standards (e.g., IFRS 9 and IFRS 15) and between leases and leaseback transactions with only variable payments (please refer to the IFRS 16 amendments issued in 2022 relating lease liability in a sale and leaseback here).</td><td>Lack of guidance is leading to diversity in practice</td></tr>
<tr><td>7</td><td>Non-monetary consideration

IFRS 16 is silent on how to measure non-monetary consideration that is part of a lease payment, as well as on whether this type of consideration meets the definition of lease payment. Therefore, diversity in practice may exist (e.g., measurement at fair value as per IFRS 15 or at the discounted value as per IFRS 16 for cash consideration?)</td><td>Lack of guidance is leading to diversity in practice</td></tr>
<tr><td>8</td><td>Distinction between lease and in-substance purchase of assets:

When drafting IFRS 16 the IASB decided not to include specific guidance (BC138-140); however, it was noted that this issue might still arise for a lease contract whose term cover the entirety of the useful life of the asset. Determining when a transaction is a lease or a in-substance purchase of asset may impact the entity's performance indicators.</td><td>Lack of guidance is leading to diversity in practice</td></tr>
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9	**Accounting for expenditures incurred before the leased assets became operational** IFRS 16 is silent on how to account for costs other than ‘initial direct costs’ (e.g., costs incurred to bring the underlying asset to the lessee’s location). Stakeholders suggested to align guidance in IFRS 16 and IAS 16 requirements.	Lack of guidance is leading to diversity in practice
10	**Accounting for leases with non-consecutive lease periods** When the lessee has the right to use an identified asset for some non-consecutive shorter periods within a longer contract period, there is lack of clarity on the determination of the lease term, the depreciation period of the ROU asset and the period over which the interest expenses on lease liability should be recognised. Applying the longer contract period rather than the accumulated period of non-consecutive use may not faithfully represent the period for which the lessee has the right to use the leased asset.	Lack of guidance is leading to diversity in practice
11	**Contract modification** Stakeholders noted that the accounting is too complex and burdensome, especially in those industries were modifications occurred frequently (e.g., retail industry). Further, it is difficult to assess whether it represents or not a separate lease, especially when a modification would both increase and decrease the scope of the lease.	Too complex and burdensome accounting requirements
12	**Low-value asset lease exemption** Stakeholders noted that the accounting of leases of low-value assets, or providing the related disclosure if the recognition exemption is applied, may be burdensome especially when, on an aggregate basis, these contracts are not material compared to total assets value. Moreover, stakeholders questioned the application of the 5,000$ threshold (IFRS 16.BC100), as it may not be consistent with the materiality assessment in IAS 1.	Too complex and burdensome accounting requirements
13	**Determination of the appropriate ROU asset depreciation period** The issue relates to how IFRS 16 requires an entity to present in the P&L some leases which combine fixed and variable lease payments not included in the RoU/LL calculation, but the RoU is depreciated on a straight-line basis over the whole lease term (i.e., including the period on which lease payments are only variable). In these situations, the effects of IFRS 16 would not reflect the economic substance of these lease contracts and would distort entities’ P&L. Based on the outreaches held so far, these scenarios that combine variable and fixed payments seem to be increasing over the last and next years.	Substance of the transaction not properly reflected in the FS

#	DESCRIPTION OF THE ISSUE	TYPE OF ISSUE
14	**Presentation requirement in the CF statement** Several stakeholders noted that diversity in practice exists in the presentation of lease payments in the statement of cash flows by applying current requirements in IFRS 16 and IAS 7. Furthermore, many stakeholders questioned the classification of lease cash flows. In particular: • preparers questioned whether having lease payments split between operating category (i.e., variable lease payments and right of use depreciation) and financing category (i.e., principal repayment) would faithfully represent lease transactions. Indeed, for many preparers the nature of the outflows related to former operating leases continues to be operating despite the single accounting model introduced by IFRS 16 (the same concern can be extended to the presentation of some lease expenses outside EBITDA in the statement of profit or loss). • users would prefer to have cash flows arising from leases fully comparable with those arising from the purchasing of assets that are financed by debt (i.e. capex outflows in the investing category and related loan in financing category).	Substance of the transaction not properly reflected in the FS

Table 2 – Detailed descriptions of issues related to interaction with other IFRS Accounting Standards

#	DESCRIPTION OF THE ISSUE	TYPE OF ISSUE
1	**IFRS 9 - Distinction between a lease modification (IFRS 16) and extinguishment of a lease liability (IFRS 9) arising from a rent concession**	Lack of guidance in the standard
2	**IFRS 9 - Application of the ECLs model under IFRS 9 to lease liabilities from the lessor's perspective** Stakeholders have called for additional clarification about the cash shortfalls used to measure ECLs.	Lack of guidance in the standard
3	**IFRS 15 - Sale and leaseback transaction** Difficulties in assessing if the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale.	Application difficulties and lack of consistent application
4	**IFRS 15 - Identifying components in lease contracts and scope** • Challenges when splitting the operating income due to leasing under IFRS 16 and arrangement of operating services under IFRS 15. • The distinction between lease and in-substance purchase contract is not clear under IFRS 16.	Application difficulties and lack of consistent application; Lack of guidance in the standard
5	**IAS 16 - Different level of certainty in assessing optional periods to define the depreciation period** Different level of certainty in assessing optional periods ('reasonably certain to exercise an extension option' applying IFRS 16) and in determining the useful life ('expected to be available for use by an entity' applying IAS 16.6).	Inconsistency across standards
6	**IAS 16 - Definition of initial direct costs** The definition of initial direct costs in IFRS 16 is not consistent with those costs directly attributable to an asset as defined in IAS 16.17.	Inconsistency across standards
7	**IAS 36 - Application of the impairment test requirements** The impairment test requirements under IAS 36 may be difficult to apply in conjunction with IFRS 16, especially when IFRS 16 causes a reduction in headroom. Indeed, while RoU assets are included in a CGU when testing the value in use ('VIU') and/or the fair value less costs of disposal ('FVLCD') is not always clear whether the related lease liabilities should be excluded.	Lack of consistent application

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8	**IFRS 3 - Accounting for lease contracts in the context of a business combination** Remeasurement of the RoU and lease liability at present value of the remaining lease payments at the date of acquisition as if the acquired lease was a new lease at acquisition date leads to different outcome compared to the measurement at inception of the lease contract. The treatment is different compared to owned PPE under IAS 16, measured at fair value in a business combination.	Lack of consistent application
9	**IFRS 10 - Sale and leaseback of a single asset entity through corporate wrapper** Sale and leaseback of a single asset entity through corporate wrapper - Analysing how the loss of control requirements in IFRS 10 interact with the sale and leaseback requirements in IFRS 16 in the context of a corporate wrapper may require further analysis. However, based on the discussion held at the IFRS IC in February 2021, the Committee recommended that the Board undertake narrow-scope standard-setting to address the submitted fact pattern and similar transactions.	Lack of consistent application
10	**IAS 37 - Accounting for onerous lease contracts** Lack of clarity about which standard has to first apply in case of onerous lease contracts.	Lack of guidance in the standard
11	**IFRS 11 - Accounting for leases in context of joint operations** Neither IFRS 11 nor IFRS 16 provide specific guidance on accounting for leases in context of joint operations. It may affect presenting information by operators on leased field assets in extractive industries (e.g., oilfields). A recent discussion at IFRS IC in March 2019 only dealt with the liability and not with the asset side of the lease and, therefore, there were issues on the way to portray some activities.	Lack of consistent application