STAFF PAPER

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Project	**Annual Improvements to IFRS Standards 2018–2020**
Paper topic	Lease Incentives (Amendment to Illustrative Examples accompanying IFRS 16): Analysis of feedback

CONTACT(S)	Nicolette Lange	nlange@ifrs.org	+44 (0) 20 7246 6924

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Introduction

1. As explained in Agenda Paper 12E, this paper analyses feedback on *Lease Incentives* (Proposed amendment to Illustrative Examples accompanying IFRS 16 *Leases)* included in the Exposure Draft *Annual Improvements to IFRS Standards 2018–2020*. The proposed amendment to Illustrative Example 13 (IE13) would remove from the example the illustration of the reimbursement of leasehold improvements by the lessor.

2. We recommend that the International Accounting Standards Board (Board) finalise the proposed amendment to IE13 accompanying IFRS 16 with no changes.

Structure of our analysis

3. This paper is structured as follows:

   (a) background (paragraph 5);

   (b) summary of feedback (paragraphs 6–18);

   (c) staff analysis (paragraphs 19–31); and

   (d) staff recommendation (paragraph 32).

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4. There are two appendices to this paper:

   (a) Appendix A—Extract from the Exposure Draft; and

   (b) Appendix B—Alternative amendment to IE13.

Background

5. Paragraphs BC1–BC3 of the Basis for Conclusions on the proposed amendment explain the background and the Board's rationale for the proposed amendment. Paragraphs BC1–BC3 state:

   > BC1 The Board was informed about the potential for confusion in applying IFRS 16 *Leases* because of how Illustrative Example 13 accompanying IFRS 16 illustrates the requirements for lease incentives. In particular, it is unclear why, in Illustrative Example 13 based on the limited facts provided, the lessee does not consider the reimbursement relating to leasehold improvements to be a lease incentive as defined in IFRS 16.
   >
   > BC2 The Board developed Illustrative Example 13 to illustrate requirements in IFRS 16 for initial and subsequent measurement of a right-of-use asset and lease liability. The inclusion in the example of payments from the lessor to the lessee (in relation to both real estate commission and leasehold improvements) was intended to illustrate when such payments meet the definition of lease incentives and when they do not. Illustrative Example 13 concludes that the lessee does not account for payments relating to leasehold improvements as a lease incentive but applies other relevant Standards. The explanation provided—'because costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset'—implies that these payments are not associated with the lease. However, to be sufficiently precise, Illustrative Example 13 should have stated more clearly that these payments did not meet the definition of lease incentives

> in IFRS 16 (that is, the payments were not associated with the lease and were not the reimbursement or assumption by the lessor of costs of the lessee because, for example, the payments reimbursed the lessee for improvements made to the lessor's asset).
>
> BC3 Because illustrative examples do not provide mandatory requirements, the requirements in IFRS 16 would prevail in case of any confusion or apparent conflict. Nonetheless, the Board proposes to amend Illustrative Example 13 to remove the potential for confusion from this example.

Summary of feedback

6. Fifty seven respondents to the Exposure Draft comment on the proposed amendment to the Illustrative Examples accompanying IFRS 16. Feedback on the proposed amendment was mixed—approximately half of respondents agree with the proposed amendment and half disagree.

7. Some of the respondents who agree with the proposed amendment say IE13 is unclear and suggest clarifying whether a reimbursement of leasehold improvements meets the definition of a lease incentive. One of these respondents suggests providing further requirements and/or illustrative examples to address more generally the accounting for lease incentives.

8. Respondents who disagree with the proposed amendment do not disagree with the Board's observation that the existing wording in IE13 could create the potential for confusion. However, they say there is diversity in determining whether reimbursements by the lessor are lease incentives—in their view, amending IE13 as proposed would not remove this diversity or resolve the potential confusion. A few of these respondents say IE13 provides useful information about a reimbursement from the lessor that the lessee does not account for as a lease incentive—in their view, removing such an illustration could add confusion.

9. All respondents who disagree with the proposed amendment suggest that the Board not finalise the amendment as proposed but, instead, consider one or both of the following:

   (a) providing additional requirements on when reimbursements qualify as lease incentives (Alternative A); or

   (b) amending IE13 to illustrate a reimbursement that is not a lease incentive (Alternative B).

10. Respondents' suggestions on these two alternatives are discussed below.

Alternative A—Providing additional requirements

11. Many respondents suggest amending IFRS 16 to include additional requirements to help entities assess whether reimbursements by lessors are lease incentives. These respondents say the existing requirements in IFRS 16 are insufficient to address this matter. For example, Nexia Australia says:

> We note that the Board withdrew SIC-15 *Operating Leases – Incentives* upon application of IFRS 16. However, neither IFRS 16 itself, the Application Guidance contained in Appendix B of that Standard, nor the Basis of Conclusions to IFRS 16 contain any further discussion or guidance on the treatment of lease incentives. As a result, we are aware of diversity in views on the application and treatment of lease incentives under IFRS 16… However, rather than solely deleting the offending paragraph as proposed in the ED, we recommend that the IASB develop and provide additional commentary and examples within IFRS 16 to clarify and illustrate the following matters:
>
> 1. The types of arrangements that meet the definition of a lease incentive…

12. Some of these respondents suggest clarifying how an entity applies the definition of lease incentives in IFRS 16, or suggest identifying circumstances in which reimbursements qualify as lease incentives. A few respondents say reimbursements

of leasehold improvements are common and should be specifically addressed by the Board. A few other respondents identify other circumstances and ask whether reimbursements in those circumstances meet the definition of lease incentives.

13. Some of these respondents suggest that, in addition to the matters noted in paragraph 12 above, the Board address other matters regarding lease incentives. For example, some respondents suggest clarifying:

    (a) how to apply the measurement requirements for right-of-use assets (paragraph 24 of IFRS 16) and lease liabilities (paragraph 27 of IFRS 16) considering the definitions of lease payments and lease incentives in IFRS 16;

    (b) the accounting for existing lease incentives on transition to IFRS 16 (IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019); and

    (c) how the accounting for lease incentives applying IFRS 16 has changed compared to that applying SIC-15.

14. KPMG says it is aware of other application questions regarding the accounting for lease incentives—nonetheless, it suggests finalising the proposed amendment and considering other matters as part of the post-implementation review of IFRS 16. The European Financial Reporting Advisory Group says this question leads to a broader question of whether leasehold improvements and restoration costs should be included in a right-of-use asset. Similarly, the UK Financial Reporting Council says there is a potential inconsistency between the accounting for leasehold improvements and that for restoration costs, which the Board could consider separately.

Alternative B—Amending proposed IE13

15. Some respondents suggest that, instead of finalising the amendment as exposed, the Board amend IE13 to explain why the reimbursement of improvements in IE13 is not a lease incentive. These respondents say doing so would provide additional clarity and reduce potential diversity in reporting. For example, Mazars says:

> By deleting all references to leasehold improvements, the Board leaves IFRS users with a former version of Example 13 stating that reimbursement of leasehold improvements by the lessor is not a lease incentive and with new Basis for Conclusions not really contradicting that statement. We consider that this situation is not satisfactory.

16. A few of these respondents say the explanation in paragraph BC2 of the proposed amendment—that explains how the amendment could have been more precisely drafted—is helpful and should be incorporated into the example. Paragraph BC2 states:

> ….Illustrative Example 13 should have stated more clearly that these payments did not meet the definition of lease incentives in IFRS 16 (that is, the payments were not associated with the lease and were not the reimbursement or assumption by the lessor of costs of the lessee because, for example, the payments reimbursed the lessee for improvements made to the lessor's asset).

17. However, a few other respondents ask whether paragraph BC2 implies that reimbursements of leasehold improvements are never lease incentives. For example, the International Organization of Securities Commissions says:

> We note that reimbursements of costs related to leasehold improvements by the lessor to the lessee are common in practice. It is unclear whether BC 2 is suggesting that the reimbursement of a leasehold improvement by the lessor is never a lease incentive, or whether underlying facts would dictate whether such reimbursements are lease incentives. In absence of clarification as to when reimbursements by the lessor to the lessee for leasehold improvements should be considered lease incentives and when they should not, we are concerned that confusion and diversity in practice will remain.

18. In addition, EY says:

> We consider that paragraph BC2 in the ED is not the appropriate place to raise a potentially contentious technical position of the Board (i.e., whether specific payments meet the definition of a lease incentive). According to paragraph 3.77 of the Due Process Handbook, the Basis for Conclusions is intended to include the Board's rationale behind the decisions it reached in developing or changing a Standard. This may include alternative solutions considered but rejected by the Board, but should not include a potentially contentious technical position of the Board that is not already included in the standard itself, as this would result in further confusion.

Staff analysis

19. Paragraph BC1 of the proposed amendment (see paragraph 5 of this paper) explains the background to the proposed amendment. The proposed amendment to IE13 is intended to remove the potential for confusion that could arise as a result of the wording in that example. In proposing the amendment, the Board neither reconsidered the requirements for lease incentives in IFRS 16 nor reconsidered the definition of lease incentives. We note that the definition of lease incentives in IFRS 16 was derived from, and is very similar to, the description of lease incentives formerly in SIC-15.

Alternative A—Providing additional requirements

20. In our view, it would be inappropriate to amend IFRS 16 to provide additional requirements on lease incentives (ie Alternative A discussed above) at this time. Doing so would:

    (a) go beyond the scope of an annual improvement—annual improvements are amendments that are limited to changes that either (i) clarify the wording in a Standard; or (ii) correct relatively minor unintended consequences, oversights or conflicts between existing requirements of Standards.[1]

(b) potentially be disruptive to the implementation of IFRS 16, given IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019.

21. Accordingly, we recommend that the Board not consider this alternative further at this time.

Alternative B—Amending proposed IE13

22. When deliberating the proposed amendment, the Board discussed two alternatives to amending IE13—namely:

(a) the proposed amendment included in the Exposure Draft (ie amending IE13 to remove the illustration of the reimbursement of leasehold improvements by the lessor); and

(b) change the fact pattern and provide additional explanation as to why the reimbursement is not a lease incentive—ie Alternative B as suggested by some respondents (see paragraphs 15–18 of this paper).

23. On balance, the Board decided to propose removing the illustration of the reimbursement from IE13. This is because it concluded that amending IE13 as discussed in paragraph 22(b) above had the potential to raise new questions, which would be unhelpful to stakeholders in implementing IFRS 16. The Board also thought it was not essential to illustrate lease incentives in an example. In considering the requirements in IFRS 16 (including the definition of lease incentives in Appendix A to the Standard), the Board concluded that little would be lost by removing this aspect of one illustrative example.

24. Nonetheless, in the light of the feedback received, and to allow the Board to compare and contrast the two alternatives, Appendix B to this paper considers what IE13 could look like if the Board were to proceed with Alternative B. In Appendix B, we

[1] Paragraphs 6.11–6.14 of the *Due Process Handbook.*

(a) update the fact pattern to state that the lessor reimburses the lessee CU7,000 for amounts spent on the building structure (the lessor's asset); and (b) explain why this reimbursement is not a lease incentive—the wording of this explanation is consistent with the wording used in paragraph BC2 of the proposed amendment (see paragraph 16 of this paper). Amending IE13 as illustrated in Appendix B would, in essence, incorporate within the Illustrative Examples the example that was included in paragraph BC2 of the proposed amendment, but with an editorial change (see explanation in paragraph 26 below).

25. The wording of paragraph BC2 does not create new requirements but, instead, explains the rationale for the proposed amendment using an example. Appendix A to IFRS 16 defines lease incentives as 'payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee'. The wording in paragraph BC2 of the proposed amendment states that (emphasis added) '…these payments *did not meet the definition* of lease incentives in IFRS 16 (that is, the payments were *not* associated with the lease and were *not* the reimbursement or assumption by the lessor of costs of the lessee…'. The paragraph then goes on to illustrate when, in the context of IE13, this would be the case—it states '…because, for example, the payments reimbursed the lessee for improvements made to the lessor's asset'. The example is one whereby the reimbursement relates to amounts spent on the lessor's asset (from which the lessor will benefit) and, thus, relates to costs of the lessor. Accordingly, the example is not, in our view, interpretative nor does it imply that reimbursements of leasehold improvements are never lease incentives.

26. Indeed, lessees typically recognise leasehold improvements as an item of property, plant and equipment, and therefore amounts paid by the lessee for such leasehold improvements are costs of the lessee. In contrast, the example set out in paragraph BC2 refers to improvements to the lessor's asset and, thus, are costs of the lessor. In Appendix B, we have editorially changed the example to refer to 'amounts spent on the lessor's asset from which the lessor will benefit', instead of 'improvements to the lessor's asset'—this is because we think 'amounts spent on the lessor's asset' would make it clearer that the example refers to costs of the lessor.

How to proceed?

27. Having considered the feedback, in our view there are two approaches available to the Board (the same two the Board considered when developing the proposed amendment), namely:

    (a) proceed with removing the illustration in IE13 as proposed; or

    (b) illustrating in IE13 a reimbursement that is not a lease incentive, using the example in paragraph BC2 (along the lines of the illustration in Appendix B).

28. If the Board considers it helpful to retain the reference to the example that was included in paragraph BC2, then we would recommend the second approach—illustrating in IE13 a reimbursement that is not a lease incentive. The example included in paragraph BC2 to explain the proposed amendment is in the nature of an illustrative example and, if retained, in our view would fit better within IE13 than in the Basis for Conclusions. In addition, as explained in paragraphs 15–18 of this paper, some respondents say it would be beneficial to amend IE13 to illustrate a reimbursement that is not a lease incentive.

29. Alternatively, the Board could proceed with removing the illustration in IE13 for the reasons noted in paragraph 23 of this paper. Although many respondents say it would be beneficial to retain an illustration (and thus disagree with the proposed amendment), many others agree with the proposal to remove the illustration. The example in paragraph BC2 also raised questions for some respondents, and there is a risk of those or other questions arising if we amend IE13 to include a new example.

30. In our view, the definition of lease incentives provides an adequate basis on which to determine whether payments from the lessor are lease incentives—in essence, that definition requires an entity to determine whether such payments are associated with the lease or reimburse costs of the lessee, or alternatively do not because, for example, they relate to costs of the lessor. Depending on the particular contractual terms and

conditions, that determination may require some judgement in some situations. However, in our view, any such judgement would not be excessive.

31. Accordingly, on balance, we recommend that the Board finalise the proposed amendment to IE13 accompanying IFRS 16 with no changes (ie removing the illustration in IE13)

Staff recommendation

32. We recommend that the Board finalise the proposed amendment to IE13 accompanying IFRS 16 with no changes.

Question 1 for the Board
Does the Board agree with the staff recommendation to finalise the proposed amendment to IE13 accompanying IFRS 16 with no changes?

Appendix A—Extract from the Exposure Draft

[Draft] Amendment to the Illustrative Examples accompanying IFRS 16 *Leases*

Part 1 of Illustrative Example 13 in paragraph IE5 is amended. New text is underlined and deleted text is struck through.

Lessee measurement (paragraphs 18–41 and B34–B41)

IE5 The following example illustrates how a lessee measures right-of-use assets and lease liabilities. It also illustrates how a lessee accounts for a change in the lease term.

Example 13—Measurement by a lessee and accounting for a change in the lease term

Part 1—Initial measurement of the right-of-use asset and the lease liability

Lessee enters into a 10-year lease of a floor of a building, with an option to extend for five years. Lease payments are CU50,000 per year during the initial term and CU55,000 per year during the optional period, all payable at the beginning of each year. To obtain the lease, Lessee incurs initial direct costs of CU20,000, of which CU15,000 relates to a payment to a former tenant occupying that floor of the building and CU5,000 relates to a commission paid to the real estate agent that arranged the lease. As an incentive to Lessee for entering into the lease, Lessor agrees to reimburse to Lessee the real estate commission of CU5,000~~ and Lessee's leasehold improvements of CU7,000~~.

At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines that the lease term is 10 years.

The interest rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, receives <u>the</u> lease incentive~~s~~ from Lessor and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

Lessee initially recognises assets and liabilities in relation to the lease as follows.

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for first year)		CU50,000
Right-of-use asset	CU20,000	
Cash (initial direct costs)		CU20,000
Cash (lease incentive)	CU5,000	
Right-of-use asset		CU5,000

~~Lessee accounts for the reimbursement of leasehold improvements from Lessor applying other relevant Standards and not as a lease incentive applying IFRS 16. This is because costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset.~~

…

Appendix B—Alternative amendment to IE13 (Alternative B)

B1. This appendix illustrates how the Board could amend existing IE13 as discussed in paragraph 24. New text is underlined and deleted text struck through.

Lessee measurement (paragraphs 18–41 and B34–B41)

IE5 The following example illustrates how a lessee measures right-of-use assets and lease liabilities. It also illustrates how a lessee accounts for a change in the lease term.

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At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines that the lease term is 10 years.

The interest rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, receives the lease incentive~~s~~ from Lessor and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

Lessee initially recognises assets and liabilities in relation to the lease as follows.

Right-of-use asset CU405,391

Lease liability		CU355,391
Cash (lease payment for first year)		CU50,000
Right-of-use asset	CU20,000	
Cash (initial direct costs)		CU20,000
Cash (lease incentive)	CU5,000	
Right-of-use asset		CU5,000

Lessee accounts for the reimbursement from Lessor of ~~leasehold improvements~~ amounts spent on the building structure ~~from Lessor~~ applying other relevant Standards and not as a lease incentive applying IFRS 16. This is because the payment is neither associated with the lease nor the reimbursement or assumption by Lessor of costs of Lessee because the payment reimburses Lessee for amounts spent on Lessor's asset (the building). Accordingly, the payment does not meet the definition of a lease incentive. ~~costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset.~~

…