
IASB[®] meeting

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Project **Post-implementation Review of IFRS 16 Leases**

Topic **Feedback summary—usefulness of information resulting from lessees’ application of judgement**

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Purpose and structure of this paper

1. This paper summarises feedback to Question 2 in the [Request for Information *Post-implementation Review of IFRS 16 Leases*](#) (RFI), which asked about the usefulness of information resulting from lessees’ application of judgement.
2. This paper is structured as follows:
 - (a) background information (paragraphs 4–5);
 - (b) overall messages (paragraphs 6–11);
 - (c) summary of comments about the usefulness of information resulting from lessees’ application of judgement relating to:
 - (i) lease term (paragraphs 12–18);
 - (ii) discount rates (paragraphs 19–20);
 - (iii) variable lease payments (paragraphs 21–23); and
 - (iv) other areas of IFRS 16 (paragraphs 24–25); and
 - (d) question for the International Accounting Standards Board (IASB).
3. This paper does not ask the IASB for any decisions.

Background information

4. Question 2 in the RFI asked stakeholders about their views on the usefulness of information resulting from lessees' application of judgement.

Question 2—Usefulness of information resulting from lessees' application of judgement

(a) Do you agree that the usefulness of financial information resulting from lessees' application of judgement is *largely* as the IASB expected? If your view is that lessees' application of judgement has a *significant* negative effect on the usefulness of financial information, please explain why.¹³

(b) Do you agree that the requirements in IFRS 16 provide a clear and sufficient basis for entities to make appropriate judgements and that the requirements can be applied consistently? If not, please explain why not.

(c) If your view is that the IASB should improve the usefulness of financial information resulting from lessees' application of judgement, please explain:

- (i) what amendments you propose the IASB make to the requirements (and how the benefits of the solution would outweigh the costs); or
- (ii) what additional information about lessees' application of judgement you propose the IASB require entities to disclose (and how the benefits would outweigh the costs).

Please refer to 'Guidance for responding to questions' on pages 7–8.

5. Question 2 was included in the RFI after considering the following initial feedback the IASB heard before publishing the RFI:
- (a) many stakeholders (mostly standard-setters and preparers) said determining the lease term involves complex judgements;
 - (b) some stakeholders said determining incremental borrowing rates involves significant judgement;
 - (c) some users said that, in some cases, the use of judgement required to determine the lease term or discount rate reduces comparability; and
 - (d) some stakeholders said it is sometimes difficult to determine which variable lease payments to include in the measurement of the lease liability.

Overall messages

6. Most stakeholders provided feedback on Question 2 in the RFI and many of them generally agreed that the usefulness of financial information resulting from lessees' application of judgement is largely as the IASB expected.
7. However, most stakeholders, including most users of financial statements (users), acknowledged that significant judgement required in determining the lease term, incremental borrowing rate or which variable lease payments to include in the lease liability, might lead to inconsistent application and reduce comparability between entities.
8. Although many stakeholders agreed that the requirements in IFRS 16 generally provide a clear and sufficient basis for entities to make appropriate judgements, they still suggested the IASB provide additional guidance, illustrative examples and specific disclosure requirements to support consistent application of the requirements and improve comparability.
9. Some stakeholders said the requirements in IFRS 16 do not provide a clear or sufficient basis for entities to make appropriate judgements and asked the IASB to consider clarifying and simplifying requirements, providing additional guidance and enhancing disclosure requirements.
10. A few stakeholders who commented said the subjective judgements made by lessees, particularly in determining lease terms and incremental borrowing rates, lead to significant variability in how similar leases are reported. Therefore, they disagreed with the statement that the usefulness of financial information resulting from lessees' application of judgements is largely as the IASB expected.
11. However, a few other stakeholders, including a few users, said:
 - (a) the exercise of judgement is a core principle in the application of principles-based standards and is necessary to reflect facts and circumstances and changing environments;

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- (b) improving the financial information resulting from the application of judgement would be challenging;
 - (c) standard-setting cannot resolve matters that indicate non-compliance with the requirements or inappropriate exercise of judgement;
 - (d) the requirements of IFRS 16 allow entities to make appropriate judgements and can be applied consistently; and
 - (e) no additional guidance is necessary.

Summary of comments about the usefulness of information resulting from lessees' application of judgement

Lease term

Feedback

- 12. Most stakeholders provided feedback on Question 2 in the RFI. Of those who commented, a few stakeholders, including a few users, expressed little or no concerns about the usefulness of information resulting from the lessees' application of judgement in determining the lease term. However, most stakeholders (including most users, standard-setters and preparers, and many accountancy bodies) raised various concerns.¹
- 13. Most stakeholders who raised concerns said determining the lease term involves complex judgements, which have a material impact on the measurement of lease liabilities and reduce comparability between entities. In their view, determining lease term is particularly challenging for complex contracts, such as those with multiple extension and termination options, 'evergreen' leases (leases that renew indefinitely) or those with tacit renewals. The judgement in determining lease term might also

¹ For more details about user feedback, see paragraphs 15–16 of Agenda Paper 7E for this meeting.

affect an entity's conclusion of whether a lease contract is eligible for the short-term lease exemption. Of those stakeholders:

- (a) many said determining whether a lessee is 'reasonably certain' to exercise (or not to exercise) extension or termination options is particularly challenging due to the significant judgement involved and inherent subjectivity. For example:
 - (i) entities are interpreting the threshold of 'reasonably certain' differently even in similar circumstances;
 - (ii) some said contracts like evergreen leases pose challenges because entities might determine the lease term based on the minimum enforceable period;
 - (iii) a few said a lessee's lease term determination is sometimes inconsistent with customary practice or expectations of how long the asset will be used by an entity; and
 - (iv) a few said there is a risk that entities might structure lease contracts to achieve desired accounting outcomes.
- (b) some said determining whether a contract is enforceable is challenging, in particular because of the lack of clear guidance on how to apply the notion of 'insignificant penalty', which results in inconsistent application.

Suggestions

14. Many stakeholders suggested providing additional guidance to that in paragraphs B34–B40 of IFRS 16 and illustrative examples to support lessees in making complex judgements, including when:
 - (a) assessing the 'reasonably certain' threshold;
 - (b) determining the period for which the contract is enforceable;
 - (c) applying the notion of 'insignificant penalty'; and
 - (d) determining the non-cancellable period.

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15. A few accounting firms and standard-setters suggested incorporating in the Standard the explanatory material included in the agenda decision [Lease Term and Useful Life of Leasehold Improvements \(IFRS 16 and IAS 16\)](#) and a few said even the agenda decision is not clear enough or the agenda decision only deals with a specific fact pattern.
16. A few stakeholders noted that paragraphs 122 and 125 of IAS 1 *Presentation of Financial Statements* require lessees to disclose information about their lease-related judgements and estimates. But many others, including many users, suggested that the IASB should enhance these requirements and explicitly require lessees to disclose information about judgements and assumptions in determining lease terms.
17. A few stakeholders suggested other targeted improvements to disclosure requirements to enhance comparability and transparency. Their suggestions included requiring lessees to disclose:
- (a) weighted-average lease terms; or
 - (b) sensitivity analysis for lease liabilities, showing how the carrying amount would have been affected by changes in lease terms.
18. A few stakeholders (mainly preparers) suggested simplifying the determination of lease terms, especially for complex contracts or contracts that renew indefinitely, for example, by providing practical benchmarks.

Discount rates

Feedback

19. Most of those who commented on Question 2 in the RFI (including most standard-setters, most users, many accountancy bodies and many preparers) raised various concerns about determining discount rates in IFRS 16.² Of those stakeholders:

² For more details about user feedback, see paragraphs 17–19 of Agenda Paper 7E for this meeting.

- (a) many said interest rates implicit in leases are rarely observable. The absence of observable inputs necessitates the use of judgement and estimates in determining incremental borrowing rates (IBRs), which leads to variations in outcomes and hinders comparability between entities.
- (b) some said different methodologies used by entities produce materially different IBRs for similar leases.
- (c) a few said consideration of entity-specific factors such as the lessee's credit risk, lease term, and nature of the underlying asset often results in variability across entities.
- (d) a few said the lack of sufficient information disclosed to understand how IBR is determined makes it difficult to analyse and compare entities.
- (e) a few stakeholders, mainly from Latin America, said:
 - (i) they observed that the IBRs used by some entities are significantly higher than the entities' observable borrowing rates, which artificially reduces the lease liabilities.
 - (ii) when an economy is subject to high inflation, applying discount rates (that incorporate expected inflation) to variable lease payments (that are not adjusted for expected inflation) results in an economically inappropriate measurement of a lease liability.

Suggestions

20. Many stakeholders made suggestions to the IASB relating to discount rate requirements which, in their view, would help to reduce complexity and variability in application. The suggestions included:
- (a) clarifying how (and providing illustrative examples) to determine an IBR in complex scenarios such as where there is no observable market data;
 - (b) explicitly requiring lessees to provide better disclosures about, for example:
 - (i) key assumptions and judgements made in determining IBR;

- (ii) methodology used in determining IBR;
 - (iii) weighted average discount rate;
 - (iv) range of possible discount rates; and
 - (v) sensitivity analysis of the lease liability to changes in the discount rate; and
- (c) introducing a single reference rate or allowing entities to use observable borrowing rates or readily available information from external sources such as a government yield curve plus a credit spread or a risk-free rate to determine a discount rate to reduce subjectivity and enhance comparability.

Variable lease payments

Feedback

21. Many of those who commented on Question 2 in the RFI (including many standard-setters and accountancy bodies and some preparers) said there is unclear or insufficient guidance to determine whether some lease payments are in-substance fixed lease payments, variable lease payments that depend on an index or rate, or variable lease payments that do not depend on an index or rate. Users commented more generally about how differences in accounting for variable lease payments that depend on an index or rate and other variable lease payments affect their analyses.³
22. Stakeholders' various concerns about variable lease payments included:
- (a) many stakeholders said the requirements do not provide a clear and sufficient basis to decide whether lease payments are in-substance fixed or 'genuinely' variable when applied to some fact patterns. This is because:
 - (i) determining whether a future event 'has no genuine possibility of not occurring' in paragraph B42(a)(i) of IFRS 16 is challenging. For

³ For more details about user feedback, see paragraph 20 of Agenda Paper 7E for this meeting.

example, in renewable electricity contracts, it is unclear whether variable lease payments linked to a nature-dependent source of electricity (such as sun and wind) are (or are not) in substance-fixed lease payments. A few said not recognising lease liabilities for such payments (which, in form, contain variability but, in substance, are unavoidable) does not reflect economic substance.

- (ii) paragraph B42(a)(ii) of IFRS 16 refers only to payments that are initially structured as variable lease payments linked to the use of the underlying asset but ‘become fixed for the remainder of the lease term’. So, it is unclear how to account for lease payments that are initially structured as variable, become fixed for only a portion of the lease term, and then become variable again.
- (b) some stakeholders said the absence of a clear definition of ‘an index or a rate’ in some cases requires the use of judgement to determine whether variable lease payments depend on an index or a rate. Practical challenges arise in particular when variable lease payments depend on an index or rate that is not linked to general market conditions, the lessee's performance or the underlying asset.

Suggestions

- 23. Some stakeholders suggested the IASB provide clearer guidance and illustrative examples to help distinguish between in-substance fixed lease payments, variable lease payments that depend on an index or rate and variable lease payments that do not depend on an index or rate. Stakeholders’ suggestions included:
 - (a) providing additional application guidance that would clarify how to interpret ‘genuine variability’ in paragraph B42(a) of IFRS 16 and ‘no genuine possibility of not occurring’ in paragraph B42(a)(i) of IFRS 16;
 - (b) clarifying how to apply the requirement in paragraph B42(a)(ii) of IFRS 16 and when lease liabilities should (or should not) be remeasured if lease

payments change between being fixed in some periods and variable in others during the lease term; and

- (c) clarifying the definition and scope of the terms ‘index’ or ‘rate’.

Other areas of IFRS 16

24. Some of those who commented on Question 2 in the RFI (mostly accountancy bodies, standard-setters and preparers) said requirements for lease modifications and reassessment of the lease liability are complex, which might lead to inconsistent application. Stakeholders’ comments included:
- (a) determining when a lessee should reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, is challenging. A few said there is not enough guidance about what constitutes ‘a significant event or a significant change in circumstances’ in paragraph 20 of IFRS 16. A few said an entity should be permitted to voluntarily reassess the lease term.
 - (b) determining whether a lease modification should be accounted for as a separate lease is challenging.
 - (c) accounting for a lease modification is complex, particularly when lease contracts change in multiple ways simultaneously.
25. A few stakeholders suggested the IASB consider incorporating agenda decisions relating to IFRS 16 published by the IFRS Interpretations Committee (including the agenda decision mentioned in paragraph 15) into the main body of the Standard (rather than as annotations) to improve the accessibility and clarity of the requirements and to help entities apply the requirements consistently.

Question for the IASB

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Do you have any comments or questions about the feedback summary in this agenda paper?