STAFF PAPER

May 2018

IASB Meeting

Project	**IFRS 16 *Leases*—Lease incentives**
Paper topic	Annual Improvement

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

Introduction

1. We have been informed about the potential for confusion regarding the treatment of lease incentives applying IFRS 16 *Leases*. The Accounting Standards Board in Canada and its IFRS Discussion Group discussed the matter. The potential for confusion arises because of how the requirements for lease incentives are illustrated in Illustrative Example 13 (IE13) accompanying IFRS 16.

2. The objective of this paper is to:

   (a) provide the Board with a summary of the matter and the staff's analysis and conclusions; and

   (b) ask the Board whether it agrees with the staff recommendation to include a proposed amendment to IE13 in its next *Annual Improvements to IFRS Standards Cycle*.

Structure of the paper

3. The paper includes the following:

   (a) background information;

   (b) staff analysis; and

   (c) Appendix A: Recommended proposed amendment to IE13 of IFRS 16.

Background information

4. Paragraphs 24 and 26 of IFRS 16 require a lessee to include lease payments in the initial measurement of the right-of-use asset and lease liability[1].

5. Appendix A to IFRS 16 defines lease payments and lease incentives as follows (**emphasis added**):

   Lease Payments:

   > Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:
   >
   > (b) fixed payments (including in-substance fixed payments), less any **lease incentives**;
   >
   > (c) variable lease payments that depend on an index or a rate;
   >
   > (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.
   >
   > For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees.
   >
   > …

   Lease incentives:

   > 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.

6. IE13 illustrates how a lessee measures right-of-use assets and lease liabilities. Part 1 of IE13 illustrates the initial measurement requirements in IFRS 16, and Part 2 of IE 13 the subsequent measurement requirements. The matter raised

[1] Lease payments made at or before the commencement date are not part of the lease liability recognised at that date but are part of the right-of-use asset.

relates to initial measurement only. The relevant excerpt from the fact pattern in Part 1 of IE13 is as follows (**emphasis added**):

> 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.**

7. The relevant excerpt from the conclusion in Part 1 of IE13 is as follows (**emphasis added**):

> At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, receives lease incentives 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 the 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**.

Question raised

8. The question raised asked why, in IE13, the lessee did not consider the reimbursement relating to leasehold improvements to be a lease incentive as defined in IFRS 16. We were informed that the illustration in IE13 has raised questions about how to read and apply the definition of lease incentives in IFRS 16.

Staff Analysis

The role of Illustrative Examples

9. Illustrative Examples accompany, but are not part of, a particular IFRS Standard. Illustrative Examples are therefore not authoritative. The rubric before the illustrative examples in IFRS 16 notes that 'they illustrate aspects of IFRS 16 but are not intended to provide interpretative guidance'. Paragraph IE1 of IFRS 16 states:

> These examples portray hypothetical situations illustrating how an entity might apply some of the requirements in IFRS 16 to particular aspects of a lease (or other contracts) on the basis of the limited facts presented. The analysis in each example is not intended to represent the only manner in which the requirements could be applied, nor are the examples intended to apply only to the specific industry illustrated.

10. Illustrative Examples are therefore not intended to provide an answer to any particular fact pattern, nor introduce new requirements or guidance. Rather, they are developed to help stakeholders understand the requirements in the Standard by illustrating their application using hypothetical examples.

The rationale for the development of IE13

11. The Board developed IE13 to illustrate the requirements in IFRS 16 for initial and subsequent measurement of a right-of-use asset and lease liability.

12. More specifically, 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 because they are associated with the lease and when not.

13. The comments received, however, highlight that the drafting of IE13 in this respect may not be as precise as it might have been. With respect to the payments from the lessor related to leasehold improvements, IE13 concludes that the lessee does not account for those payments as lease incentives applying IFRS 16 but applies other relevant Standards. The explanation provided—'this is 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 associated with the leasehold improvements (which the lessee accounts for applying other Standards), and not with the lease. However, in order to be sufficiently precise, we think the fact pattern and explanation provided in IE13 would have needed to state more clearly that these payments did not meet the definition of lease incentives in IFRS 16 (ie the payments were not associated with the lease and were not the reimbursement or assumption by the lessor of costs of the lessee). For example, IE13 might have explained that these payments from the lessor relate to the cost of leasehold improvements (paid for by the lessee) from which the lessor expected to benefit, or alternatively explained that these payments were negotiated separately from the lease.

14. With the benefit of hindsight, we think that the fact pattern and explanation in IE13 regarding payments from the lessor relating to leasehold improvements could have been drafted more precisely than they were.

Should any change be proposed to IE13 in this respect?

15. Illustrative Examples provide non-authoritative material that accompanies a particular Standard. Because Illustrative Examples are not authoritative, some might question whether there is a need to propose any amendment to IE13 even if

the Board were to agree with the staff's analysis in paragraphs 11-14 above. Some might suggest that if there is any possible confusion between the authoritative requirements in IFRS 16 and the non-authoritative illustration in IE13, then an entity would apply the requirements in the Standard and, thus, there is no need to propose a change to IE13. In addition, proposing a change, albeit to non-authoritative material accompanying IFRS 16, so close to the effective date of 1 January 2019 has the potential to be disruptive to entities' implementation activities.

16. Although strictly speaking an amendment to IE13 may not be required, we see benefit in removing the potential for confusion that has been highlighted to us. Any amendment to IE13 would not change the authoritative requirements in IFRS 16 and, thus, the potential for disruption to implementation would be expected to be low.

17. The Board's Annual Improvements Cycle exists for amendments that are limited to changes that either:

    (b) clarify the wording in a Standard; or

    (c) correct relatively minor unintended consequences, oversights or conflicts between existing requirements of Standards[2].

18. If the Board agrees with our analysis above, then we think a change to IE13 regarding payments from the lessor relating to leasehold improvements would meet the criteria for Annual Improvements.

Proposed Amendment to IE13

19. Appendix A to this paper outlines our recommended proposed amendment to IE13—we recommend removing from the example the illustration of payments from the lessor relating to leasehold improvements.

20. We considered two possible ways of amending IE13:

    (a) the first is as recommended in Appendix A to this paper.

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

(b) the second is to change the fact pattern and explanation along the lines of the following:

(i) to change the fact pattern to state that the lessor agrees to pay CU7,000 to the lessee for costs of leasehold improvements from which the lessor expects to benefit.

(ii) to change the explanation within the conclusion to state that the payment from the lessor for leasehold improvements is not associated with the lease, nor does it represent the reimbursement or assumption of costs of the lessee.

21. We recommend the first of these options on the grounds that:

(a) the second option has the potential to raise new questions, which would be unhelpful to stakeholders in implementing IFRS 16; and

(b) we think it is not essential to illustrate lease incentives in an example. In considering all the requirements in IFRS 16, we think little is lost by removing this aspect of IE13.

Transition Requirements

22. Because the amendment proposed is to non-authoritative material accompanying IFRS 16, there is no need for the Board to consider transition or an effective date.

Question for the Board
Does the Board agree with our recommendation to propose an amendment to Illustrative Example 13 accompanying IFRS 16 in its next *Annual Improvements to IFRS Standards Cycle*? Appendix A to this paper outlines the recommended proposed amendment.

Appendix A: Recommended proposed amendment to Illustrative Example 13 in paragraph IE5 of IFRS 16

A1. If the Board decides to propose an amendment to IE13, we recommend removing from the example the illustration of payments from the lessor relating to leasehold improvements as follows (text proposed for deletion is struck through):

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 lease incentives 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.~~