STAFF PAPER

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IASB® meeting

Project	**Second Comprehensive Review of the *IFRS for SMEs*® Standard**
Paper topic	Towards an Exposure Draft—IFRS 16 *Leases*

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Introduction

1. This paper discusses whether and how to propose amending the *IFRS for SMEs* Standard to align with IFRS 16 *Leases*, including possible simplifications.

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard. Also, for the purpose of this paper, an SME is an SME that is a lessee, unless otherwise mentioned.

3. This paper should be read in conjunction with Agenda Paper 30B *Summary of feedback on aligning the IFRS for SMEs Standard with IFRS 16* Leases, which provides a summary of all forms of feedback on the Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard*, published in January 2020, and from supplementary meetings, and the recommendations of the SME Implementation Group (SMEIG) on the alignment of Section 20 *Leases* of the *IFRS for SMEs* Standard with IFRS 16. Appendix B to Agenda Paper 30B also sets out the Board's rationale in the Request for Information for asking views on aligning the *IFRS for SMEs* Standard with IFRS 16.

Purpose of this meeting

4. The purpose of this meeting is to ask the International Accounting Standards Board (Board) to:

   (a) consider all forms of feedback on the Request for Information and from supplementary meetings, and the recommendations of the SMEIG on the possible approaches to aligning Section 20 of the *IFRS for SMEs* Standard with IFRS 16 (refer to Agenda Paper 30B); and

   (b) decide whether and how to propose amending the *IFRS for SMEs* Standard to align Section 20 with IFRS 16 making some simplifications (refer to this paper).

Summary of staff recommendations

5. The staff recommend the Board develop amendments to the *IFRS for SMEs* Standard to align Section 20 of the *IFRS for SMEs* Standard with IFRS 16, with simplifications for:

   (a) the determination of the discount rate—if the interest rate implicit in the lease cannot be readily determined, an SME would be permitted to make an accounting policy choice by class of underlying asset to use as the discount rate either the SME's incremental borrowing rate or a risk-free rate (determined using a period comparable with that of the lease term).

   (b) the subsequent measurement of the lease liability (reassessment)—an SME would be required to remeasure its lease only in the event of a substantive change in the lease term or in the event of a change in the assessment of an option to purchase the underlying asset. The SME would reflect the effect of any other change in the lease in the income statement for the period in which the change occurs.

Structure of the paper

6. In the Request for Information, the Board sought views on aligning Section 20 with IFRS 16 making some simplifications. To proceed forward, the questions for the Board in this paper are structured as follow:

    (a) an overall question about the relevance to SMEs of the improvements to financial reporting that were introduced by IFRS 16 (paragraph 27 of this paper);

    (b) a question for each of the possible simplifications to the requirements of IFRS 16 discussed in this paper (paragraphs 41, 53, 66, 77 and 87 of this paper); and

    (c) an overall final question about the development of proposed amendments to Section 20 to align with IFRS 16, with the simplifications recommended in this paper (paragraph 93 of this paper).

7. This paper includes the staff analysis for the following topics:

    (a) alignment of Section 20 with IFRS 16—applying the alignment principles (paragraphs 9–27 of this paper).

    (b) possible simplifications for the following topics in IFRS 16 (paragraphs 28–87 of this paper):

        (i) recognition of leases (recognition exemptions) (paragraphs 29–41 of this paper);

        (ii) definition of ‘lease term’ (paragraphs 42–53 of this paper);

        (iii) discount rate (paragraphs 54–66 of this paper);

        (iv) lease payments (paragraphs 67–77 of this paper); and

        (v) subsequent measurement (reassessment) of the lease liability (paragraphs 78–87 of this paper).

    (c) possible simplifications to the disclosure requirements and language of IFRS 16 (paragraphs 88–92 of this paper).

(d) overall staff recommendation and final question for the Board (paragraph 93 of this paper).

8. Next steps (paragraph 94 of this paper).

Alignment of Section 20 with IFRS 16—applying the alignment principles

9. In considering whether and how to align the *IFRS for SMEs* Standard with new and amended IFRS Standards, at its March 2021 meeting, the Board tentatively decided to apply the alignment approach with IFRS Standards as the starting point. In doing so, the Board has agreed to apply three alignment principles—relevance to SMEs, simplicity and faithful representation—including the assessment of costs and benefits (Agenda Paper 30 outlines the Board's alignment approach).

10. As discussed in Agenda Paper 30B, the feedback on aligning the *IFRS for SMEs* Standard with IFRS 16 does not raise questions regarding the relevance of the topic to SMEs. However, there is some discussion on whether the simplifications discussed in the Request for Information would lead to faithful representation. In addition, there is some concern about the cost of aligning the *IFRS for SME*s Standard with IFRS 16. Some respondents and some SMEIG members suggested improving lease accounting by improving disclosure requirements for operating leases instead of aligning the *IFRS for SMEs* Standard with IFRS 16.

11. In the light of all forms of feedback on the Request for Information and from supplementary meetings, the SMEIG discussed the following three possible approaches at its meeting on 9 September 2021:

(a) Approach 1—aligning Section 20 with IFRS 16 with possible simplifications (as described in the Request for Information);

(b) Approach 2—aligning Section 20 with the main principle of IFRS 16 by extending the existing accounting for finance leases in the *IFRS for SMEs* Standard to all leases; and

(c) Approach 3—improving disclosure requirements for operating leases without changing the recognition and measurement requirements in the *IFRS for SMEs* Standard.

12. The staff note that:

(a) Approach 2 could be considered a subset of Approach 1. Approach 2 would align the *IFRS for SMEs* Standard with IFRS 16 by removing the classification between finance and operating leases and using simplified measurements requirements that are already in Section 20.

(b) Approach 3 would be inconsistent with the Board's tentative decision to follow the alignment approach in this review, particularly, with the Board's conclusion, in developing IFRS 16, that a lessee obtains the right to use an underlying asset (an asset) and has an obligation to make lease payments (a liability).

13. Accordingly, the staff analysis in this paper:

(a) applies the three alignment principles to Approach 1; and

(b) supports the staff recommendation to simplify some requirements of IFRS 16 when aligning Section 20 of the *IFRS for SMEs* Standard with IFRS 16.

Relevance to SMEs

14. Relevance to SMEs is determined by assessing whether IFRS 16 requirements would make a difference in users' decisions of financial statements prepared applying the *IFRS for SMEs* Standard.[1] During development of the Request for Information, the Board noted that a 2015 report *The Use of Leasing Amongst European SMEs* stated that leases provide the third most important source of finance for SMEs, with around 40% of SMEs using leases.[2] Requiring SMEs to recognise their leases in their

[1] Paragraph 33 of the Request for Information.
[2] Paragraph B67 of the Request for Information.

statement of financial position would result in greater transparency about this important source of finance.

15. A small number of stakeholders said a simplified model for operating leases—where a lessee would classify all cash payments within operating activities in the statement of cash flows—would meet the information needs of users of SMEs financial statements. However, the feedback from many respondents to the Request for Information generally does not raise questions regarding the topic's relevance to SMEs and indicates that:

    (a) IFRS 16 introduces improvements to financial reporting, provides useful information to users and results in greater transparency of SMEs' liabilities and assets.

    (b) in developing IFRS 16 the Board agreed that a lessee obtains an asset and a liability. This position applies equally to an entity applying the *IFRS for SMEs* Standard and entity applying IFRS 16. Entities are financially assessed using similar financial indicators, regardless of whether they have public accountability, their size and complexity.

    (c) property leases for long periods are becoming more typical, increasing the need to recognise rights-of-use assets and related liabilities to make significant leases visible in primary financial statements.

16. For the above reasons, the staff conclude that IFRS 16 satisfies the relevance condition for SMEs.

Simplicity

17. IFRS 16 eliminates the requirement for a lessee to classify leases as either operating or finance leases and requires the lessee to apply a single model to account for its leases. The move to a single model could be perceived itself as a simplification—compared to the requirements in Section 20 of the *IFRS for SMEs* Standard which are based on IAS 17 *Leases*—along with the short-term lease and low-value asset lease

exemptions. However, this long-term simplification might come with some short-term pain on transition.

18. The Board therefore set out additional possible simplifications in the Request for Information. Feedback on the Request for Information indicates that applying some of the possible simplifications:

   (a) could be challenging as they might result in new application questions that preparers did not raise when implementing IFRS 16.

   (b) could require adjustments to software developed to comply with the requirements in IFRS 16.

   (c) might not faithfully represent an SME's assets and liabilities. For example, changing the definition of the lease term to exclude optional periods may make the lease accounting model easier to apply but could also result in misleading representation if option clauses are introduced in lease agreements or used as a way of reducing the amounts of assets and liabilities recognised in the statement of financial position. The resulting financial statements would, arguably, not faithfully represent the lessee's position regarding future commitments.

19. The staff believe that retaining the existing accounting for lessees in Section 20 of the *IFRS for SMEs* Standard, for example, until the completion of the Post-implementation Review of IFRS 16, would delay potential improvements and lead to a major divergence on a significant matter affecting most SMEs. Conversely, the alignment of Section 20 of the *IFRS for SMEs* Standard with IFRS 16 would bring uniformity in lease accounting—for example, ensuring that all leases are reflected in the statement of financial position—and would improve comparability and provide better-quality information to users. Paragraphs 28–87 of this paper discuss possible simplifications for SMEs to the requirements in IFRS 16, including the staff's assessment of whether these simplifications would lead to faithful representation.

20. On the principle of simplicity, the staff finally note that IFRS 16 also features a host of different transition options and practical expedients, some of which can be elected independently of each other and even on a lease-by-lease basis. If the Board agree

with the staff recommendations summarised in paragraph 5 of this paper, when drafting the exposure draft, the staff plan to incorporate these reliefs with possible simplified language.

Faithful representation

21. The principle of faithful representation is intended to help the Board assess whether financial statements prepared applying the *IFRS for SMEs* Standard would faithfully represent the substance of economic phenomena in words and numbers. Simplifications that would result in financial statements that do not meet this criterion could damage the quality of information reported to users.[3]

22. As discussed in paragraph 19 of this paper, the staff analysis in this paper discusses each possible simplification separately to assess whether it is appropriate to reflect the simplification in the *IFRS for SMEs* Standard and does not, perhaps in concert with other simplifications, significantly reduce the usefulness of the information in the financial statements.

Costs and benefit consideration

23. Taking the cost and benefit considerations into account, leveraging the timing element, which is an essential step in the review, the staff note:

    (a) lenders are becoming increasingly familiar with the model of accounting for leases in IFRS 16. Delaying alignment of the requirements in the *IFRS for SMEs* Standard with those in IFRS 16 would carry the risk of the *IFRS for SMEs* Standard no longer represent up-to-date thinking about how to account for leases, creating a gap between the accounting practices applied by SMEs and entities applying IFRS Standards. In assessing the repayment capacity of SMEs, lenders consider cash flows associated to leases and the maturity of lease commitments. In some jurisdictions lenders access the information about

[3] Paragraph 36 of the Request for Information.

leases via centralised credit registers if the information is not available in SME financial statements.

(b) leases typically provide finance in circumstances when traditional bank facilities might not be granted on the grounds that a lessor often has greater security because of its ownership of the asset.[4] In applying the requirements in IFRS 16, preparers, including those with less sophisticated financing departments, need to determine the discount rate charged in a lease and may identify improvements in how they finance and operate their business.

(c) most leases to which SMEs are parties do not include complex terms and conditions. Vehicles are one of the most frequently leased asset types across industries.

24. Although some respondents are concerned about the need to balance benefits to users with cost and effort for preparers—because IFRS 16 includes complexity for SMEs (for example, the determination of the lease term and the lease payments to measure the lease liability)—the staff expect these costs to be limited and also justifiable for most SMEs applying the *IFRS for SMEs* Standard (for example, a workload on SMEs proportionate to the value of the output to their stakeholders). This is because feedback indicates that most SMEs do not have sophisticated leases arrangements (for example, energy/power purchase agreements) and that the single model is simpler than the existing requirements in Section 20 and therefore it is not expected in itself to bring significant implementation challenges for most SMEs. This expectation is consistent with the views of other respondents—as they said the implementation of IFRS 16 is expected to be less challenging for SMEs compared to larger entities because the terms and conditions of most leases entered into by SMEs do not include complex features such as variable lease payments.

25. As discussed in paragraph 20 of this paper, the staff plan to incorporate reliefs (already in IFRS 16), but with simplified language—that will affect the costs and timing of SME implementation project, including SME financial statements for years to come.

[4] *IFRS 16 Effects Analysis*.

26. Therefore, the staff believe the benefits to preparers and users of SME financial statements would outweigh the costs for preparers of applying an aligned Section 20 to IFRS 16, incorporating reliefs (already in IFRS 16) and some additional simplifications.

Staff recommendation and question for the Board

27. In the light of the staff analysis and the Board's tentative decision in March 2021 to use the alignment approach in developing proposed amendments to the *IFRS for SMEs* Standard, the staff think the improvements to financial reporting introduced by IFRS 16 are relevant to SMEs and recommend the Board consider the simplifications discussed in this paper to align Section 20 with IFRS 16.

Question 1 for the Board
Does the Board agree that the improvements to financial reporting that were introduced by IFRS 16 are relevant to SMEs? If the Board agrees, the staff will ask the Board to consider the simplifications discussed in this paper and vote on questions 2–7 of this paper. If the Board disagrees, the staff would like to know if the Board would like to consider at a future Board meeting Approach 3 discussed in paragraph 11(c) of this paper.

Possible simplifications to the topics in IFRS 16

28. Simplifying how an SME applies the aligned Section 20 will help minimise the implementation costs on transition and the application costs for SMEs. The possible simplifications to the recognition and measurement requirements of IFRS 16 are analysed as follows.

1—Simplifications for the recognition of leases (recognition exemptions)

29. To reduce the costs for lessees, IFRS 16 provides recognition exemptions for short-term leases and low-value asset leases. This section of the paper considers whether the Board should expand the scope of the recognition exemptions in IFRS 16 to provide additional cost reliefs to SMEs as suggested by some respondents to the Request for Information.

Short-term leases

30. Applying IFRS 16 a lessee may elect not to apply the recognition, measurement and presentation requirements of IFRS 16 to short-term leases. IFRS 16 defines a short-term lease as:

> A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

31. Some respondents suggested developing a different definition of a short-term lease for inclusion in the *IFRS for SMEs* Standard, including:

    (a) defining a short-term lease as a lease that, at the commencement date, has a lease term of 30 months or less.

    (b) defining a short-term lease as a lease that, that at the commencement date, has a lease term of seven years or less and requiring disclosure of annual fixed lease costs for the first seven years of a lease. According to the respondents who submitted this suggestion:

        (i) seven years is the most common term of operating leases; and

        (ii) the Board could strengthen transparency about lease commitment through improved disclosures rather than through recognition of leases with a lease term of less than seven years in the statement of financial position.

32. Paragraphs BC91–BC96 of the Basis for Conclusions on IFRS 16 explain the considerations for short-term leases made by the Board when developing IFRS 16. The Board considered expanding the lease exemption to leases of more than 12 months, but rejected the approach because, for example, three-year leases are more likely to give rise to material assets and liabilities than 12-month leases, and the objective of IFRS 16 was to ensure greater transparency about an entity's leasing activities. The Board also considered the risks that leases could be structured to meet the short-term lease exemption—for example, the economic disincentive for lessors to grant shorter term leases.

33. Consistent with the conclusions reached by the Board for IFRS 16, the staff think:

    (a) the feedback did not provide sufficient reasons to reach different conclusions for SMEs; and

    (b) requiring 'improved disclosures rather than through recognition of leases' would be inconsistent with the Board's tentative decision to follow an alignment approach as set out in paragraph 12(b) of this paper.

34. The staff, therefore, recommend the Board retain the recognition exemption for short-term leases unchanged when aligning the *IFRS for SMEs* Standard with IFRS 16.

Low-value asset leases

35. Applying IFRS 16 a lessee may elect not to apply the recognition, measurement and presentation requirements of IFRS 16 to leases for which the underlying asset is of low value (as described in paragraphs B3–B8 of IFRS 16). Paragraph BC100 of the Basis for Conclusions on IFRS 16 explains that in deciding on the exemption

> …the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of US$5,000 or less.

36. Some respondents suggested developing a different recognition exemption for inclusion in the *IFRS for SMEs* Standard, including:

(a) permitting a lessee not to apply the recognition, measurement and presentation requirements of IFRS 16 to leases for which the value of the underlying asset when new is of US$50,000 or less. According to the respondents who submitted this suggestion setting a threshold would avoid subjectivity in interpreting the requirements, provide greater transparency, reduce application costs for SMEs, make it easier for users of SME financial statements to understand how a lessee has elected to use the recognition exemption and improve comparability.

(b) permitting a lessee not to apply the recognition, measurement and presentation requirements of IFRS 16 to leases of specified categories of assets that are generally of low value—for example, tablets and smartphones—rather to leases that are considered having low value based on monetary amount.

37. The staff note that the reference to a quantitative amount in the Basis for Conclusions on IFRS 16 is intended to help entities identify leased assets that the exemption might capture and addressed some of the operationality concerns raised by outreach participants when the Board developed IFRS 16.

38. Regarding the suggestion in paragraph 36(a) of this paper, the staff do not believe that referring to a different quantitative amount in the Basis for Conclusions on the *IFRS for SMEs* Standard or setting a quantitative threshold in the Standard would be appropriate for SMEs because:

(a) paragraph BC100 of the Basis for Conclusions on IFRS 16 explains that the exemption is based on the value of the asset being leased, rather than on the size or nature of the entity that leases the asset. The Board concluded the assessment of whether an underlying asset is of low value should not be affected by the size, nature or circumstances of the lessee.

(b) entities eligible to apply the *IFRS for SMEs* Standard have different sizes and include large entities that do not have public accountability, for which the same conclusions reached by the Board when developing IFRS 16 apply.

(c) for smaller SMEs the assets and liabilities arising from leases within the order of magnitude of US$5,000 are more likely to be considered material. Hence, any alternative amount could be arbitrary.

(d) the order of magnitude of US$5,000 is arguably already familiar to many entities.

39. Regarding the suggestion in paragraph 36(b) of this paper, the staff agree with some respondents that providing an indicative list of assets that would meet the definition of low value could simplify the application of the low-value assets exemption for SMEs. However, the staff note that any list is unlikely to be comprehensive and might need to be updated to reflect any new type of assets being leased, which might give rise to new application questions on the exemption.

40. The staff therefore recommend the Board retain the recognition exemption for low-value asset leases unchanged when aligning the *IFRS for SMEs* Standard with IFRS 16.

Staff recommendation and question for the Board

41. In the light of the staff analysis, the staff recommend the Board incorporate in the *IFRS for SMEs* Standard the recognition exemptions for short-term leases and low-value asset leases as set out in paragraph 5 of IFRS 16.

Question 2 for the Board
Does the Board agree with the staff recommendation to incorporate in the *IFRS for SMEs* Standard the recognition exemptions for short-term leases and low-value asset leases as set out in paragraph 5 of IFRS 16?

2—Simplifications for the definition of 'lease term'

42. Section 20 of the *IFRS for SMEs* Standard does not currently include a definition of lease term. This is one of the differences between IAS 17 and Section 20 listed in Appendix A to Agenda Paper 30B.

43. Applying IFRS 16, the determination of the lease term:

    (a) is a key input to measure the lease liability—IFRS 16 requires a lessee to measure a lease liability at the present value of the lease payments for the right to use the underlying asset during the *lease term*;

    (b) affects whether a lease is eligible for the short-term recognition exemption—IFRS 16 defines a short-term lease as a lease that, at the commencement date, has a *lease term* or 12 months or less (see paragraphs 30–34 of this paper); and

    (c) affects the classification of leases by lessors—examples of situations in IFRS 16 that would normally lead a lessor to classify a lease as a finance lease include the *lease term* being for the major part of the economic life of the underlying asset (see paragraph 63 of IFRS 16).

44. Given this critical role of the lease term to apply the requirements of IFRS 16, the staff think it is essential for the *IFRS for SMEs* Standard to include a definition of lease term to help SMEs to apply the *IFRS for SMEs* Standard if the Standard is aligned with IFRS 16.

45. SMEs with material off-balance sheet leases are expected to incur costs to determine the lease term. This section of the paper therefore considers whether the Board could simplify the requirements for lease term when aligning the *IFRS for SMEs* Standard with IFRS 16.

46. IFRS 16 defines the lease term as the non-cancellable period of a lease for which a lessee has the right to use an underlying asset, together with any optional periods that the lessee is reasonably certain to use. An entity shall consider all relevant facts and

circumstances that create an economic incentive for the lessee to exercise or not to exercise the options.[5]

47. In 2019, the IFRS Interpretations Committee (Committee) was asked how to determine the lease term of cancellable or renewable leases; particularly, when applying paragraph B34 of IFRS 16 and assessing 'no more than an insignificant penalty'. In November 2019, the Committee published its conclusion that when determining the lease term, an entity always considers the broader economics of the contract—not just the narrow contractual terms.[6] The analysis of such discussion demonstrated that in determining the lease term, an entity first determines the contract's enforceable period and non-cancellable period. It then determines where—within the range between the non-cancellable period (minimum lease term) and the enforceable period (maximum lease term)—the lease term falls.

48. The Request for Information set out one possible simplification to the lease term: changing the definition of the lease term to 'the non-cancellable period for which an entity is required to comply with the lease'. This means an entity:

   (a) would not consider any options included in the lease in the measurement of the lease liability; and

   (b) would account for any subsequent extension to the lease term as a new lease.

49. Many respondents, and a small number of SMEIG members, expressed concerns about this simplification. They said:

   (a) options to extend or terminate leases and rolling contracts (for example, renewable leases) are widespread in lease arrangements.

   (b) it is essential that these options are assessed as part of the lease term to:

      (i) reflect the economic substance of these lease arrangements in the measurement of lease liabilities;

      (ii) reduce structuring opportunities; and

[5] Paragraphs 18–19 of IFRS 16.
[6] IFRIC Update, November 2019.

(iii) account for lease arrangements faithfully representing their substance.

50. The staff think that:

(a) if an SME has a simple lease contract (for example, with no options) the simplification set out in paragraph 48 of this paper would not be relevant. The lease's non-cancellable period, the lease term, and the enforceable period may all be the same.

(b) if an SME has a complex lease contract (for example, with options) the simplification would be relevant but might have an inappropriate outcome—for example, the SME might significantly underestimate its lease liabilities.

51. Paragraph BC156 of the Basis for Conclusions on IFRS 16 explains that 'the lease term should reflect an entity's reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information'. The staff think that trying to simplify the definition of 'lease term' by ignoring options:

(a) could be perceived as inconsistent with IFRS 16 principles—as it could lead an SME not reflecting its reasonable expectation of the period during which the underlying asset will be used. For example, the existence of non-removable significant leasehold improvements impacts the assessment as to whether an entity is reasonably certain to extend (or not to terminate) a lease. Hence, ignoring the options could lead to inaccurate estimates of the lease term and also of the useful life of non-removable significant leasehold improvements.

(b) may result in SMEs improperly determining the lease term, leading to inaccurate measurement of the lease obligation and inappropriate conclusions about eligibility for the short-term lease exemption for lessees.

(c) could affect the lease classification assessment for lessors.

52. Therefore, the staff think that the Board should not propose any simplification of the 'lease term' when aligning the *IFRS for SMEs* Standard with IFRS 16. If an SME were to apply the simplification set out in the Request for Information, the outcome

would not faithfully represent in words and numbers the activities of the SME in its financial statements.

Staff recommendation and question for the Board

53. In the light of the staff analysis, the staff recommend the Board incorporate in the *IFRS for SMEs* Standard the definition of lease term as set out in IFRS 16.

Question 3 for the Board
Does the Board agree with the staff recommendation to incorporate the definition of lease term as set out in IFRS 16?

3—Simplifications for the discount rate

54. For finance leases, Section 20 of the *IFRS for SMEs* Standard requires an SME to discount the minimum lease payments using the interest rate implicit in the lease. If this rate cannot be determined, the SME shall use its incremental borrowing rate.

55. IFRS 16 requires lease payments to be discounted using the interest rate implicit in the lease, if that can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.[7] The lessee's incremental borrowing rate is a lease-specific rate that the Board defined 'to take into account the terms and conditions of the lease'.[8] Paragraph BC162 of the Basis for Conclusions on IFRS 16 explains that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point.

56. SMEs with material off-balance sheet leases are expected to incur costs to measure lease assets and lease liabilities at the present value of future lease payments mainly due to the need to determine a discount rate for each lease (other

[7] Paragraph 26 of IFRS 16.
[8] Paragraph BC162 of the Basis for Conclusions on IFRS 16.

than for short-term leases and low-value asset leases). Determining appropriate discount rates and documenting the basis for these determinations will be a challenge for SMEs. This section of the paper therefore considers whether the Board could simplify the requirements for the discount rate when aligning the *IFRS for SMEs* Standard with IFRS 16.

Simplification for the discount rate set out in the Request for Information

57. One of the possible simplifications, as set out in the Request for Information, is permitting an SME to use a discount rate by reference to market yields on high-quality corporate bonds if the interest rate implicit in the lease and the lessee's incremental borrowing rate cannot be readily determined. The rate of return for high-quality corporate bonds reflects the time value of money and would include a risk allowance for the risk associated with the liability. Hence it is appropriate to discount the lease liability.

58. Respondents to the Request for Information generally welcomed an option to use a discount rate by reference to market yields on high-quality corporate bonds. However, some respondents expressed concerns that:

    (a) market yields on high-quality corporate bonds may not be reflective of the risk associated with the lease liability because they are one proxy for discount rate and other proxies may exist. SMEs should not be restricted from using a discount rate by reference to an alternative source when this serves as a more suitable proxy, according to these respondents.

    (b) SMEs do not have easy access to such information.

59. A small number of respondents suggested permitting an SME to use a discount rate by reference to the yield on government bonds if there is no deep market in high-quality corporate bonds.

Possible alternative discount rates

60. The staff note that IFRS 16 is substantially converged with Topic 842 *Leases* in US GAAP and that Topic 842 includes some simplifications about the discount rate that lessees that are not public business entities use to measure their leases:

(a) applying Topic 842, lessees that are not public business entities are currently allowed to make an accounting policy election to use a risk-free rate as the discount rate for all leases. The FASB provided this election to relieve those lessees from having to calculate an incremental borrowing rate, which could create unnecessary cost and complexity.

(b) as part of the Post-Implementation Review of Topic 842, some stakeholders expressed reluctance to use the election to use a risk-free rate for all leases because, in the current economic environment, the use of a risk-free rate (for example, a US Treasury rate), which is low compared with their expected average incremental borrowing rates, would result in a significant overstatement of an entity's lease liabilities and right-of-use assets.

(c) to address the concerns expressed by these stakeholders, the FASB is currently finalising some amendments to Topic 842 to allow lessees that are not public business entities to make an accounting policy election to use a risk-free rate as the discount rate by class of underlying asset, rather than for all leases. The FASB acknowledged that a lessee may prefer to use its incremental borrowing rate for more significant leases, such as real estate leases, for which transactions may be less frequent and of higher value. However, the lessee may prefer to use a risk-free rate for less significant leases.

(d) in finalising some amendments to Topic 842, the FASB has decided to retain a risk-free rate for the discount rate accounting policy election, rather than another specified rate, such as a corporate bond rate or the prime rate. The FASB considered the characteristics that make a risk-free rate an operable rate. For example, those characteristics would include that the rate is publicly published by a reliable source and available for differing maturities (lease terms). The FASB considered specifying a corporate bond rate as the discount rate, noting that such rates are used in other topics in US GAAP. However, corporate bond rates are not publicly published by a reliable source. Rather, an average corporate bond rate is made up of underlying data (individual bond issues) that are not aggregated in a publicly available forum. The underlying data (for example, general data or specific industry data) used to calculate a corporate bond rate affect the rate. Those factors caused the FASB to conclude that specifying a corporate bond rate instead of a risk-free rate would add cost and complexity to the application for smaller entities. The FASB also questioned the basis for choosing a specific credit-rating category (for example, low investment grade or high yield) that would apply to the broad range of sizes and types of entities that are not public business entities.[9]

61. The staff have considered three alternative ways of simplifying requirements for the discount rate when aligning the *IFRS for SMEs* Standard with IFRS 16:

(a) require an SME to use *market yields on high-quality corporate bonds*—as described in the Request for Information—if the interest rate implicit in the lease and the SME's incremental borrowing rate cannot be readily determined (Approach 1);

(b) require an SME to use *yields on government bonds* if all the following conditions are met:

(i) the interest rate implicit in the lease cannot be readily determined;

(ii) the SME's incremental borrowing rate cannot be readily determined; and

(iii) there is no deep market in high-quality corporate bonds (Approach 2).

(c) permit an SME to use *risk-free rate instead of the SME's incremental borrowing rate* by class of underlying asset if the interest rate implicit in the lease cannot be readily determined (Approach 3).

62. This table compares the three alternatives.

[9] Paragraph BC18 of proposed Accounting Standards Update *Leases (Topic 842).*

	Pros	Cons
Approach 1 *(Market yields on high-quality corporate bonds)*	• It includes a risk allowance for the risk associated with the liability.	• It might not be reflective of the risk associated with the lease liability—other proxies may exist. • SMEs do not have easy access to such information, as it might not be publicly published by a reliable source.
Approach 2 *(Yields on government bonds)*	• It is publicly published by a reliable source and available for differing maturities (lease terms).	• It might not be reflective of the risk associated with the lease liability, particularly in the expected near-term interest rate environment.
Approach 3 *(Risk-free rate instead of incremental borrowing rate)*	• It is published by a reliable source and available for differing maturities (lease terms). • It gives flexibility to use the incremental borrowing rate for more significant leases—mitigating the 'uneconomic effects' issue—and to use a risk-free rate for less significant leases.	• It might not be reflective of the risk associated with the lease liability.

63. A corporate bond rate is a kind of composite rate that leads to challenges about the population and methods used to derive it. Therefore, the staff think that a corporate bond rate of a specific credit rating would not represent a significant improvement versus the use of the risk-free rate—compared with the incremental borrowing rate.

64. Conversely, permitting an SME to use a risk-free rate instead of its incremental borrowing rate by class of underlying asset if the interest rate implicit in the lease cannot be readily determined:

    (a) allows SMEs to use its incremental borrowing rate for more significant leases, while using a risk-free rate for less significant leases.

    (b) avoids creating unnecessary cost and complexity.

    (c) provides an outcome that faithful represents the lease liability.

65. Requiring an SMEs to apply the option by class of underlying asset would be consistent with the application of other requirements in IFRS 16, such as the application of the short-term lease exemption.

Staff recommendation and question for the Board

66. In the light of the staff analysis, the staff recommend the Board permit an SME to make an accounting policy choice by class of underlying asset to use as the discount rate either the SME's incremental borrowing rate or a risk-free rate (determined using a period comparable with that of the lease term), if the interest rate implicit in the lease cannot be readily determined.

Question 4 for the Board
Does the Board agree with the staff recommendation to simplify the determination of the discount rate for SMEs as discussed in paragraph 66 of this paper?

4—Simplifications for lease payments

67. IFRS 16 requires a lessee to include the following lease payments in the measurement of the lease liability:

    (a) fixed payments (including in-substance fixed payments);

    (b) variable lease payments that depend on an index or a rate;

(c) amounts expected to be payable by the lessee under residual value guarantees;

(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.

68. The Request for Information sought views on whether and how to simplify the IFRS 16 requirements on different areas, including variable lease payments, but without setting out any possible simplification for lease payments. The feedback from respondents does not address this area of IFRS 16 in detail, but, within the context of supporting simplifying the language of IFRS 16, some respondents mentioned they would welcome simplifications in the language used for lease payments, which includes in-substance fixed lease payments.

69. IFRS 16:

(a) describes in-substance fixed lease payments as payments that may, in form, contain variability but that, in substance, are unavoidable; and

(b) provides examples of situations when in-substance lease payments exist.[10]

70. Section 20 of the *IFRS for SMEs* Standard does not currently define 'contingent rent'. This is one of the differences between IAS 17 and Section 20 (refer to Appendix A to Agenda Paper 30B). When aligning Section 20 with IFRS 16 a question arises on whether to simplify the requirements about lease payments for example by omitting the requirements in IFRS 16 about in-substance fixed lease payments so that:

(a) lease payments required to be included in the measurement of an SME's lease liability would be those mentioned in paragraph 67 of this paper without specifying whether fixed payments would include in-substance fixed lease payments. This is likely to result in the SME including only the payments that are fixed in the measurement of its lease liability

[10] Paragraph B42 of IFRS 16.

(b) lease payments that are subjective to variability, other than that those that depend on an index or rate, would not be required to be included in the measurement of the lease liability. Instead, these payments would be recognised in the income statement in the period when the event or condition that triggers those payments occur, without assessing whether they meet the definition of in-substance fixed lease payments.

71. The staff have considered two possible alternatives:

(a) incorporate the requirements about in-substance fixed lease payments in the *IFRS for SMEs* Standard when aligning the Standard with IFRS 16.

(b) omit the requirements about in-substance fixed lease payments in the *IFRS for SMEs* Standard when aligning the Standard with IFRS 16. This alternative would result in requiring an SME to include in the measurement of the lease liability fixed payments without specifying whether these fixed payments include in-substance fixed lease payments or describing what in-substance fixed lease payments are (omit the requirements of paragraph B42 of IFRS 16).

72. This table compares the two alternatives.

	Pros	**Cons**
Incorporate the requirements about in-substance fixed lease payments	• Identifying an in-substance fixed lease payment seems to be straightforward in many cases.	• Judgement is required in some cases—for example, to determine whether there is no genuine underlying variability.
Omit the requirements about in-substance fixed lease payments	• It reduces cost and complexity by removing the need to assess the existence of in-substance fixed payments in a lease.	• It could encourage structuring a lease arrangement to include material in-substance lease payments, resulting in accounting that does not faithfully represent

		the substance of the lease arrangement.

73. The staff think that:

(a) if an SME has a simple contract (for example, with genuine variable lease payments not subject to 'higher of' and 'lower of' complex-clauses),[11] omitting the requirements of IFRS 16 for in-substance lease payments would not be relevant. It would be straightforward for the SME to assess which lease payments should be included in the measurement of the lease liability. For example, either the payments are unavoidable (fixed lease payments) or avoidable (fully variable linked to future performance or use of an underlying asset).

(b) if an SME has a complex contract (for example, with lease payments structured with 'higher of' and 'lower of' clauses), omitting the requirements of IFRS 16 for in-substance lease payments would provide some relief, by removing the need for the SME to assess the existence of in-substance fixed lease payments in the contract. However, it might have an inappropriate outcome—particularly, in the event a lessee could make more than one set of payments, but it must make at least one of those sets of payments (sometimes referred to as a 'higher of' clause). In that case, the contract might include an in-substance fixed lease payment that would be excluded from the measurement of the lease liability (there may be a minimum payment without the genuine possibility of avoiding it, and the avoidable part is only the payment that will exceed that minimum amount).

[11] Some leases specify that the lease payments are calculated periodically as the 'higher of' or 'lower of' two amounts—often, these amounts are based on an index or a rate.

74. Paragraph BC164 of the Basis for Conclusions on IFRS 16 explains that:

    (a) in-substance fixed lease payments are unavoidable and, thus, are economically indistinguishable from fixed lease payments; and

    (b) the approach for in-substance fixed lease payments in IFRS 16 is similar to the way in which entities applied IAS 17, even though IAS 17 did not include explicit requirements in this respect.

75. The staff think that trying to omit the requirements of IFRS 16 for in-substance fixed lease payments could be perceived as inconsistent with IFRS 16 principles. It could create new questions or issues for a concept that was generally understood and applied before the issuance of IFRS 16 itself.

76. Therefore, the staff think that the Board should include the requirements of IFRS 16 about in-substance fixed lease payments when aligning the *IFRS for SMEs* Standard with IFRS 16. Otherwise, the outcome of applying the *IFRS for SMEs* Standard might not faithfully represent in words and numbers the activities of the SME in its financial statements.

Staff recommendation and question for the Board

77. In the light of the staff analysis, the staff recommend the Board incorporate in the *IFRS for SMEs* Standard the requirements of IFRS 16 about in-substance fixed lease payments unchanged.

Question 5 for the Board
Does the Board agree with the staff recommendation to incorporate in the *IFRS for SMEs* Standard the requirements of IFRS 16 about in-substance fixed lease payments unchanged?

5—Simplification for subsequent measurement (reassessment) of the lease liability

78. IFRS 16 sets out the accounting for changes in lease payments during the contract term. IFRS 16 specifies requirements for:

    (a) changes in the lease term and the assessment of an option to purchase the underlying asset; and

    (b) changes in lease payments arising from a change in amounts expected to be payable under residual value guarantees or in an index or rate used to determine lease payments.

79. Otherwise, the accounting required by IFRS 16 for a change in lease payments depends on whether that change meets the definition of a lease modification.[12] The staff note that IAS 17 (and consequently Section 20 of the *IFRS for SMEs* Standard) did not address the accounting for lease modifications and the Board concluded it would be useful to include a general framework for accounting for lease modifications in IFRS 16 because modifications occur frequently for many types of leases. Accordingly, the staff think that including the requirements in IFRS 16 for lease modifications unchanged in the *IFRS for SMEs* Standard would provide guidance to SMEs on how to account for any lease modifications.

80. If a change in lease payments does not result from a lease modification, the change in a lease payment would generally be accounted for as either:

    (a) a variable lease payment, if the payment was not originally included in the measurement of the lease liability. In this case a lessee generally recognises the change in payments in the income statement in the period in which the event or condition that triggers those payments occurs; or

    (b) a reassessment of the lease liability, if the payment was originally included in the measurement of the lease liability. In this case a lessee generally adjusts

[12] IFRS 16 defines a lease modification as 'a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term)'.

the right-of-use asset for the amount of the remeasurement of the lease liability.

81. IFRS 16 requires a lessee to remeasure the lease liability to reflect changes to the lease payments (due to reassessment) if there is a change in:

(a) the lease term (using a revised discount rate);

(b) the assessment of a purchase option (using a revised discount rate);

(c) the amounts expected to be payable under residual value guarantees (using an unchanged discount rate); and

(d) future lease payments resulting from a change in an index or rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review (using an unchanged discount rate).[13] [14]

82. SMEs are expected to incur costs to remeasure lease liabilities to reflect reassessment. Tracking events that could trigger reassessment—for example, tracking whether there is a change in the cash flows resulting from a change in the reference index or rate (when the adjustment to the lease payments takes effect)—will be a challenge for SMEs. This section of the paper therefore considers whether the Board could simplify the requirements for the reassessment of the lease liability when aligning the *IFRS for SMEs* Standard with IFRS 16.

83. The Request for Information set out one possible simplification to the requirements for subsequent measurement of the lease liability (reassessment): requiring an SME to remeasure its lease only in the event of a substantive change in the lease term. The SME would reflect the effect of any other change in the lease in the income statement for the period in which the change occurs.

84. A small number of respondents commented on this simplification and said the reassessment of lease liabilities may be burdensome and costly, especially if a lessee has many leases—for example, by frequently tracking the changes in the index or rate

[13] Paragraphs 39, 40, 42 of IFRS 16.
[14] Unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

used to determine the revised lease payments. Some other respondents suggested an SME applies the requirements of Section 11 of the *IFRS for SMEs* Standard—about the subsequent measurement of finance leases.[15] Even though applying the requirements of Section 11 could lead to the same outcome as the possible simplification, the staff think requiring an SME to apply the requirements of Section 11 to measure its leases subsequently would be inconsistent with the Board's tentative decision to follow the alignment approach in this review.

85. When developing the Request for Information the Board considered that, when a lease contains optional periods, remeasurement of the lease liability is unlikely to be onerous because the threshold for reassessment is high. In essence, IFRS 16 requires reassessment of the lease term after its initial determination only when the entity takes actions that could significantly affect the lease term. Accordingly, changes to the lease term—and thereby a reassessment of the discount rate and lease payments—are expected only in a small number of cases.[16] Even though the Request for Information sought views on requiring an SME to remeasure its lease only in the event of a substantive change in the lease term, the staff believe that the rationale for setting out the simplification for the reassessment of the lease term in the Request for Information applies equally if there is a change in the assessment of an option to purchase the underlying asset—that is, the threshold for the reassessment of a purchase option, considering the events and circumstances described in paragraphs 20–21 of IFRS 16 in the context of a purchase option, is high and therefore is unlikely to be onerous.[17] Accordingly, the staff think that an SME should be required to remeasure its lease only in the event of a substantive change in the lease term (due to the reassessment of options or change in the non-cancellable period) or in the event of a change in the assessment of an option to purchase the underlying asset (considering the events and circumstances described for a change in the lease term but in the context of a purchase option).

[15] Paragraph 20.11 of the *IFRS for SMEs* Standard states that, for finance leases, 'a lessee shall apportion minimum lease payments between the finance charge and the reduction of the outstanding liability using the effective interest method (see paragraphs 11.15–11.20 of the Standard).

[16] Paragraph B41 of IFRS 16.

[17] Paragraph 40(b) of IFRS 16.

86. The staff think that the cost of requiring SMEs to apply IFRS 16 requirements unchanged for the reassessment of the lease liability might outweigh the benefits for users of SMEs' financial statements. Accordingly, the staff think that applying the possible simplification would avoid unnecessary cost and complexity, particularly by not requiring SMEs to track events that could trigger reassessment as described in paragraph 82 of this paper—also, the total expenses related to leases recognised in the income statement by an SME would be the same, regardless of whether the SME remeasures the lease liability for change in future lease payments resulting from a change in an index or rate.

Staff recommendation and question for the Board

87. In the light of the staff analysis, the staff recommend the Board incorporate in the *IFRS for SMEs* Standard the simplification of the requirements for subsequent measurement of the lease liability (reassessment) by requiring an SME to:

    (a) remeasure its lease only in the event of a substantive change in the lease term (due to the reassessment of options or change in the non-cancellable period) or in the event of a change in the assessment of an option to purchase the underlying asset (assessed considering the events and circumstances described for a change in the lease term but in the context of a purchase option).

    (b) reflect the effect of any other change in the lease—changes in the amounts expected to be payable under residual value guarantees and changes future lease payments resulting from a change in an index or rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review—in the income statement for the period in which the change occurs.

Question 6 for the Board
Does the Board agree with the staff recommendation to simplify the subsequent measurement of the lease liability (reassessment) for SMEs as discussed in paragraph 87 of this paper?

Possible simplifications to the disclosure requirements and language of IFRS 16

88. In addition to seeking views on possible simplifications to the recognition and measurement requirements of IFRS 16 (discussed in paragraphs 28–87 of this paper), in the Request for Information, the Board sought views on:

    (a) retaining the existing finance lease disclosures applying the *IFRS for SMEs* Standard; and

    (b) simplifying the language of the Standard.

89. Most respondents supported retaining the finance lease disclosures in Section 20 unchanged. Their reasons included that these disclosures are relevant, working well and more straightforward than those in IFRS 16. Some respondents who supported retaining the finance lease disclosures in Section 20 unchanged suggested the Board expand the disclosures to require an SME to disclose, for example, information about future cash outflows related to options that are not reflected in the measurement of lease liabilities, and the narrative explanation of the SME's exposure to variable lease payments. A small number of respondents expressed concerns that the finance lease disclosures currently in Section 20 may not meet the alignment principle of faithful representation.

90. The Exposure Draft *Subsidiaries without Public Accountability: Disclosures* published in July 2021 includes a proposal about the disclosure requirements of IFRS 16.[18] Therefore, the staff would consider the stakeholders' feedback on this Exposure Draft when aligning the *IFRS for SMEs* Standard with IFRS 16. The staff

[18] Paragraphs 100–109 of the Exposure Draft *Subsidiaries without Public Accountability: Disclosures.*

plan to bring a paper on the possible simplifications to the disclosure requirements of IFRS 16 to a future Board meeting.

91. Most respondents also supported simplifying the language of IFRS 16. Some of these respondents said that, for example, using less technical or sophisticated language would be helpful for SMEs and the users of their financial statements to better understand the requirements in the aligned Section 20. Some respondents who supported simplifying the language of the aligned Section 20 also said that where the language in IFRS 16 is simple, it should not be further simplified; otherwise, it could lead to unnecessary complexity or uncertainty in the understandability of the main principles in IFRS 16.

92. The staff would like to spend further time considering how to simplify the language without impacting the main principles in IFRS 16. The staff plan to consider this upon the progression of developing proposals for an exposure draft. In doing so, as described in paragraph 20 of this paper, the staff will also have in mind to incorporate reliefs (already in IFRS 16), but with simplifying the language, where possible.

Overall staff recommendation and final question for the Board

93. In the light of the staff analysis in this paper, the staff recommend the Board develop proposed amendments to Section 20 of the *IFRS for SMEs* Standard to align with IFRS 16, with the recommended simplifications for the determination of the discount rate and the subsequent measurement of the lease liability (reassessment) (see paragraph 5 of this paper).

Question 7 for the Board
Does the Board agree to develop proposed amendments to Section 20 of the *IFRS for SMEs* Standard to align with IFRS 16, with simplifications for the determination of the discount rate and the subsequent measurement of the lease liability (reassessment), as discussed in paragraph 93 of this paper?

Next steps

94. If the Board agree with the staff recommendations, the staff will develop proposals for an exposure draft incorporating the simplifications as set out in paragraph 5 of this paper. The staff also will bring a paper to the Board about possible simplifications to the disclosure requirements in IFRS 16 at a future meeting.