Joint EFRAG FR TEG-UP meeting
14 May 2024
Paper 07-01
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PIR of IFRS 16 *Leases*

EFRAG PREPARATORY WORK

Joint EFRAG FR TEG and User Panel meeting

14 May 2024

DISCLAIMER

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OBJECTIVE OF THE SESSION

- The objectives of this session are to:
  - Provide members with an overview of the project and the EFRAG Secretariat's preparatory work in anticipation of the IASB Post-Implementation Review of IFRS 16 *Leases* ('IFRS 16 PIR');
  - Present the summary of the feedback received by the EFRAG online surveys to preparers, auditors, national standard setters, regulators and users. **For further details please refer to agenda papers 07-02 and 07-03**;
  - Present a preliminary overview of the key general messages and the application issues identified so far through various outreach activities conducted in addition to the surveys; and
  - Seek EFRAG FR TEG and User Panel (UP) members' views on the overall assessment, the issues identified at this preliminary stage and on any potential issues not identified by the EFRAG Secretariat.
  - Receive recommendations for the upcoming workplan

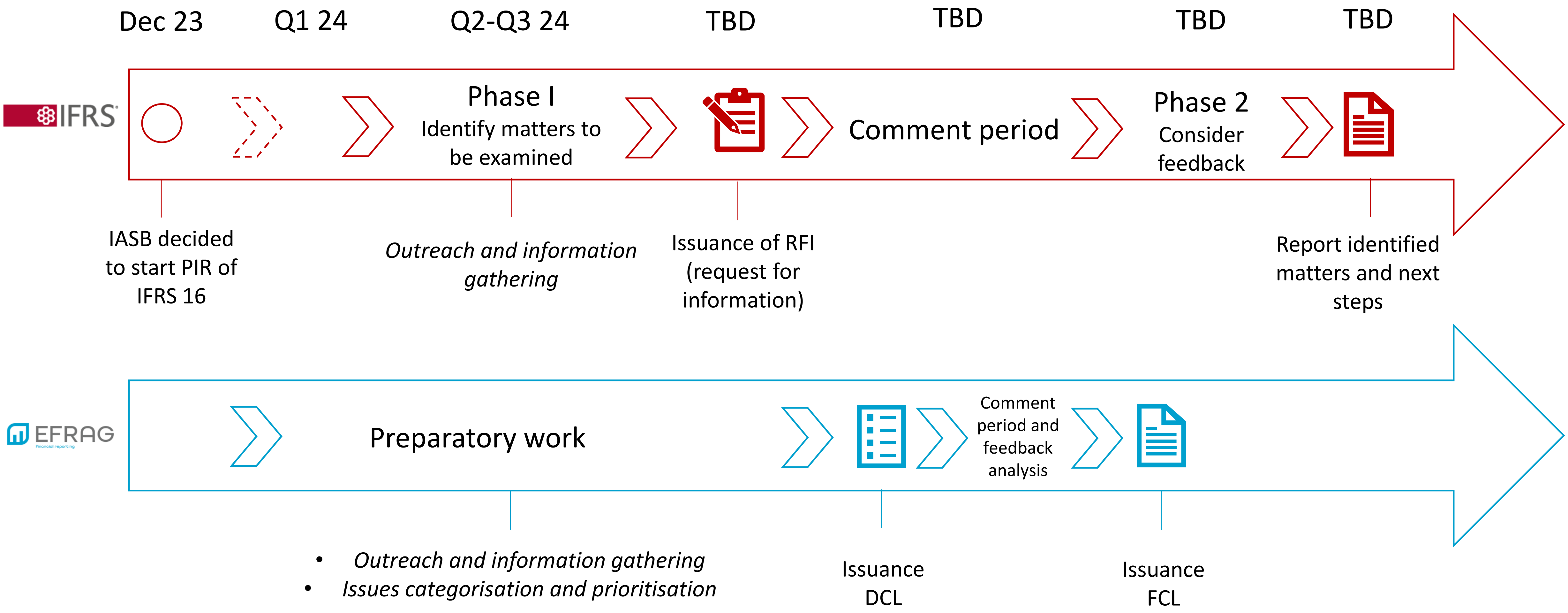
STRUCTURE OF THIS PAPER

- The structure of this paper can be summarised as follows:
  - Overview of the IASB project and of the EFRAG Secretariat's preparatory work *(slide 5-9)*;
  - Summary of the main feedback received by the EFRAG online surveys to preparers, auditors, national standard setters, regulators and users *(slide 10-13)*;
  - Preliminary overview of the key general messages so far through various outreach activities conducted in addition to the surveys in relation to:
    - Overall assessment of IFRS 16 *(slide 14-15)*
    - Disclosure requirements *(slide 16-17)*
    - Recognition, measurement and presentation requirements, including application issues arising from the application of them *(slide 18-22);* and
    - Application issues arising from the interaction with other IFRS Accounting Standards *(slide 23-29).*

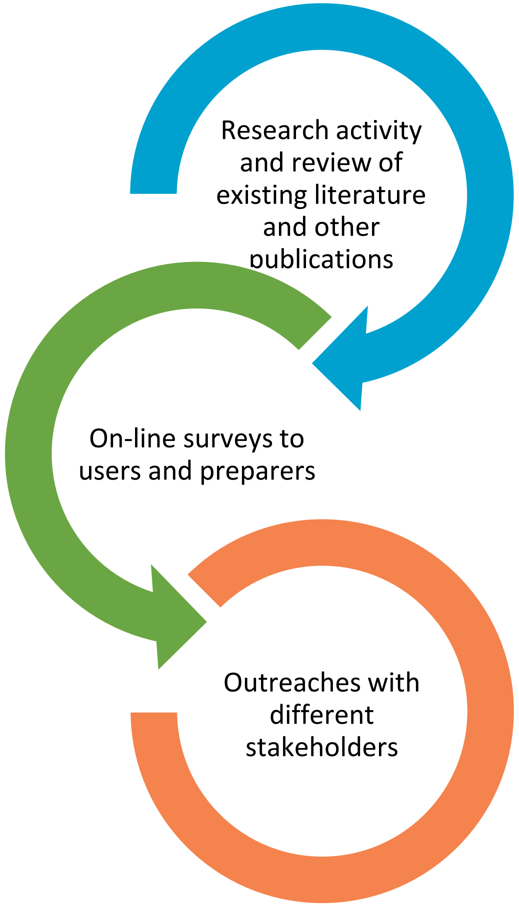
POST-IMPLEMENTATION REVIEW – WHAT ARE THE OBJECTIVES?

- During the PIR, the IASB will assess the effect of IFRS 16 (and its subsequent amendments) on users, preparers and auditors. More specifically, the IASB will assess whether:
    - there are fundamental questions (fatal flaws) about the clarity and suitability of the core objective or principles in IFRS 16 (e.g., existing diversity in practice);
    - the benefits to users of financial statements of the information arising from applying IFRS 16 requirements are significantly lower than expected; and
    - the costs of applying IFRS 16 requirements and auditing and enforcing their application are significantly greater than expected.
- These assessments help the IASB determine what, if any, action it might take relating to IFRS 16. **The PIR is not intended to open up the redeliberation on points of disagreement on the Standard, unless there are new elements to consider**.

POST-IMPLEMENTATION REVIEW – WHAT IS THE PROCESS?



EFRAG PREPARATORY WORK



- The **review of existing literature** includes the review of IFRS 16 issues raised to the IFRS Interpretation Committee (IFRS IC), those included in the enforcement decisions on financial statements issued by ESMA and a selection of academic papers.
- The **on-line surveys** have been launched in February with a comment period that ended on 22 April 2024.
- **Outreaches** with different stakeholders are still ongoing (please refer to the following slide for further details).
- EFRAG preparatory work aims at developping a preliminary list of application challenges and proposed recommendations that will be further discussed, categorised and prioritised by EFRAG FR TEG and FRB in preparation of EFRAG comment letter in response to the IASB RFI.

EFRAG PREPARATORY WORK – OUTREACHES (1/2)

So far, the EFRAG Secretariat conducted the following outreaches:

Preparers	Users	Auditors	Other organisations	EFRAG working groups**
• French preparers operating in the retail industry (January 2024) • German preparers operating in the automotive industry (April and May 2024)	• Members of the International Valuation Standards Council (March 2024)	• Meeting with representatives of large audit firms (March-April 2024)	• European Public Real Estate Association (EPRA)* • Leaseurope* • National Standard Setters	• EFRAG FIWG (06 May 2024) • EFRAG Academic Panel (08 May 2024)

* At this stage, both organisations did not indicate fundamental application issues based on the preliminary feedback received from their members. However, follow-up meetings will be conducted.

** An oral update will be provided if members should raise application issues in addition to those already summarised in the following slides.

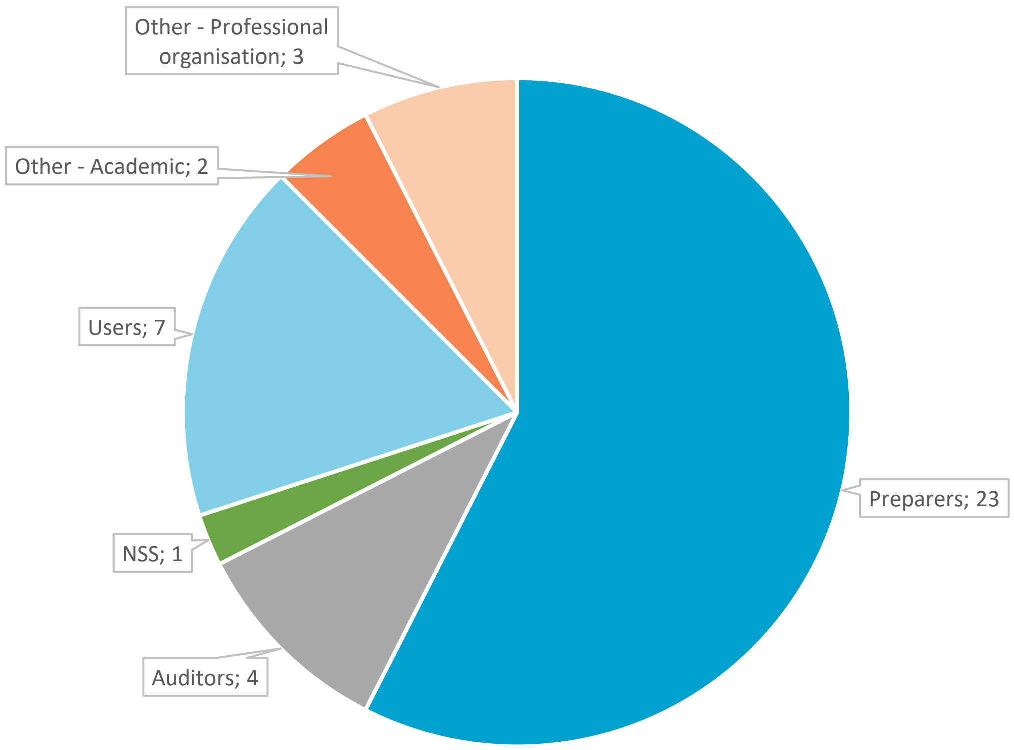
EFRAG PREPARATORY WORK – OUTREACHES (2/2)

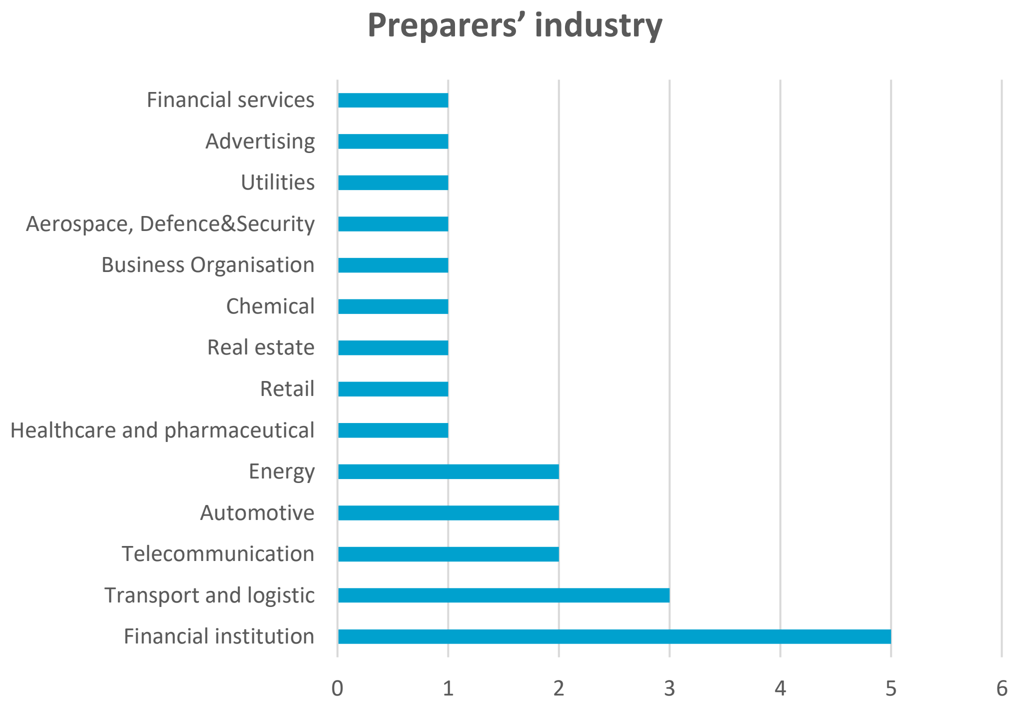
Furthermore, our envisaged work plan includes the following outreaches to be performed over the next months:

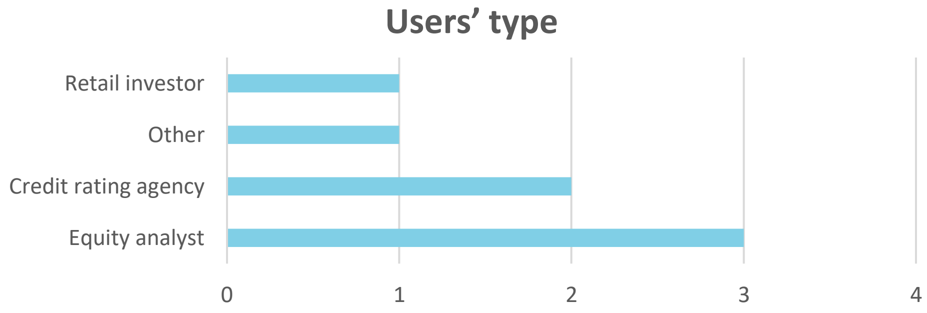
Preparers	Users	Auditors	Other organisations	EFRAG working groups
• Follow-up meetings with respondents to EFRAG survey to preparers (from June 2024)	• Follow-up meetings with respondents to EFRAG survey to users (from June 2024) • Discussion of the topic with EFFASS and CRUF in a later stage of the project	• Follow-up meetings with representatives of large audit firms (From June 2024)	• Follow-up meetings with EPRA and Leaseurope (from June 2024) – after first summarised written feedback received • Meeting with IFRS 16 tools providers • National Standard Setters working groups	• EFRAG User Panel (14 May 2024) • EFRAG IAWG (28 May 2024)

EFRAG PREPARATORY WORK – ONLINE SURVEYS (1/4)

EFRAG received **40 completed surveys** as follows:







EFRAG PREPARATORY WORK – ONLINE SURVEYS (2/4)
OVERALL ASSESSMENT OF IFRS 16

Preparers

- The **majority** (52%) considered that **IFRS 16 is generally working as intended**, but there is **room for improvement**
- **Mixed views** on whether IFRS 16 achieves a fair **cost-benefit balance**
- Most significant **costs**:
  - adjusted KPIs
  - software implementation
  - data collection and maintenance
- Most significant **benefits**:
  - improved internal control
  - improved data quality and transparency

Users

- The **majority** (57%) considered that **IFRS 16 is working as intended**
- Overall, **IFRS 16 increased**: information transparency, better information on entity's leverage and users' ability to estimate future cash flows
- Overall, information **comparability slightly increased** but structuring opportunities still remain
- The **majority** considered that IFRS 16 has **decreased users' costs** for obtaining useful information
- All respondents experienced an **increased use of adjusted alternative performance measures** to neutralise IFRS 16 impacts

EFRAG PREPARATORY WORK – ONLINE SURVEYS (2/4)
DISCLOSURE REQUIREMENTS

Preparers

- The **majority** of respondents (62%) noted that presentation and disclosure requirements **result in useful information to users and achieve the balance between the costs and benefits**

- Some respondents **questioned the cost-benefit balance** relating the following disclosure requirements:
    - expenses related to leases of low-value assets, to variable lease payments, to short-term leases, to interest on lease liabilities => high manual workload
    - the lease liability maturity analysis => difficult to gather information

- The **most costly** disclosures for preparers are:
    - Disclosures related to variable lease payments
    - Breakdown of lease payments across maturity buckets;
    - Income from subleasing right of use assets

Users

- The **majority** of respondents (57%) stated that IFRS 16 disclosure requirements **provide useful information** both under lessee and lessor perspectives.

- Respondents also indicated the following **areas of improvement**:
    - the maturity analysis of lease liabilities; and
    - total cash outflow for leases

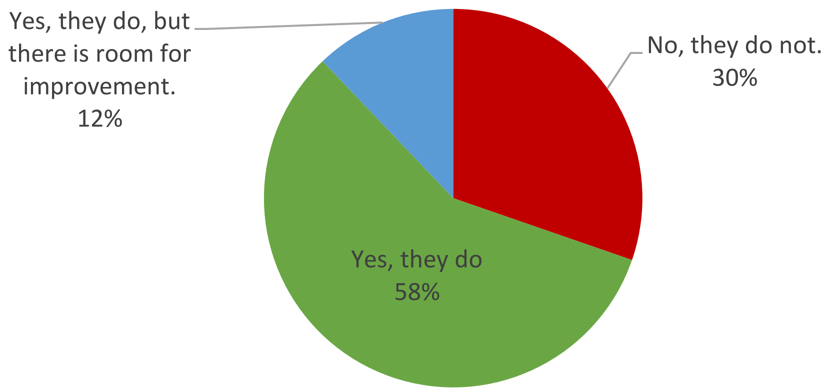
- The **most useful** disclosures for users:
    - Interest expense on lease liabilities
    - Lessors’ disclosures for finance leases
    - Additional qualitative and quantitative information (IFRS 16.59)
    - Expenses related to variable lease payments

EFRAG PREPARATORY WORK – ONLINE SURVEYS (2/4)
RECOGNITION, MEASUREMENT AND PRESENTATION REQUIREMENTS

EFRAG

Preparers

Faithful representation of lease transactions under IFRS 16?

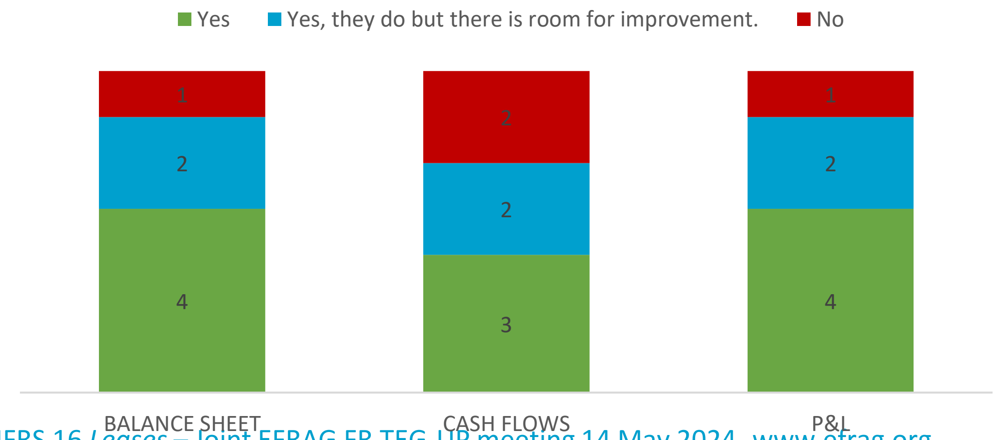


- **Main areas of improvement:**
  - Existing structuring opportunities
  - Users' understandability of lease accounting should be improved
  - Risk of misleading information especially in the P&L and in the cash flow statement (increased use of adjusted KPI)
  - Increased use of judgement and estimations

Users

- **Balance sheet**: diversity in practice in determining the lease term, preference for operating and financing distinction for lease liabilities
- **P&L**: Interest expenses may be understated, disclosures related to MPMs could be improved, need for better information related to depreciation, interest, split between operating and financing leases
- **Cash Flows**: concerns on flexibility under IAS 7, no clear distinction between capital and interest components, preference for IAS 17 presentation

Faithful representation of lease transactions under IFRS 16?



WHAT WE LEARNT SO FAR?
OVERALL ASSESSMENT OF IFRS 16

Preparers

- Mixed views mainly based on the industry and the amount of lease contracts;
- In some industries, too costly and complex implementation (e.g., data collection, IT tools and staff training, acquisition-integration); on-going costs are still relevant.
- Limited benefits and mainly related to the internal control system;
- High level of judgments may impair comparability among entities (e.g., discount rates, lease term);
- Increased deviation between internal and external reporting;
- As practice has been developed, limited appetite for changes.

Users

- Overall, it is working well and resulted in entity providing more and more useful information about lease transactions;
- However, some users (e.g., valuation specialists) still prefer using pre-IFRS 16 figures for their analysis;
- IFRS 16 improves information comparability, provides useful information and a more faithful presentation of lease transactions in the financial statements;
- Differences between IFRS and US GAAP still remain. However, enhanced disclosures could help users in dealing with the lack of comparability;
- Structuring opportunities still remain, albeit limited.

Auditors and NSS

- Overall, it is working well, and some application issues could go beyond the scope of this PIR;
- More faithful representation of lease transactions in the FS, improved transparency and comparability;
- Implementation phase required a lot of effort from the entities to develop new internal procedures to collect data and to understand the requirements. However, to date practice developed;
- High level of judgments required in some areas might lead to some diversity in practice (e.g., scoping, lease term and discount rate).

QUESTIONS FOR EFRAG FR TEG AND USER PANEL MEMBERS

OVERALL ASSESSMENT

- Q1 – Do you agree with the **overall assessment of IFRS 16** summarised in slide 14? Do you have any further input relevant for this PIR?
- Q2 – In your view, did the implementation of IFRS 16 impact **entities' reporting** to stakeholders related to performance in the statements of financial position, profit or loss and cash flows (e.g., introduction of **new Alternative Performance Measures**)? If yes, do users of financial statements consider such alternative performance measures helpful for their analyses?

WHAT WE LEARNT SO FAR?

DISCLOSURE REQUIREMENTS

Preparers	Users	Auditors and NSS
• Some disclosures reduce the cost relief arising from the recognition exemptions (e.g., expenses about leases of low-value assets, short term leases and variable lease payments); • Difficult to provide disclosure about variable lease payments (e.g., distinction between lease and non-lease component is difficult); • Current IT systems should support entities in providing information required.	• They welcome improvements resulting from IFRS 16. However, for some entities room for improvements still remain; • Call for more disclosures about the discount rate, the average lease term (and related key assumptions), the depreciation schedule and variable lease payments (e.g., key variability drivers and expenses classification).	• No major application issues identified, not even in terms of information auditability.

QUESTIONS FOR EFRAG FR TEG AND USER PANEL MEMBERS

DISCLOSURE REQUIREMENTS

- Q3 - Do you agree with the feedback on the IFRS 16 disclosure requirements summarised in slide 16? Do you have any further input relevant for this PIR?

WHAT WE LEARNT SO FAR?

RECOGNITION, MEASUREMENT AND PRESENTATION REQUIREMENTS

Preparers

- Application issues mainly refer to more judgmental areas, such as assessing whether a lease exists, the lease term and the discount rate;
- Retail industry expressed concerns about current presentation of leases in the FS as it is distorted by significant variable payments still off-balance sheet. Others did not express concerns or even appreciated not to have the obligation to estimate variable lease payments;
- Some suggestions to align IFRS 16 to US GAAP as the latter would allow more simplifications.

Users

- Suggestion for a clearer distinction in the P&L and in the CF of the expenses/cash flows related to leases;
- If significant variable payments exist, having a clear picture of the total lease expenses is still difficult and the amounts reflected in the BS may be underestimated;
- A few users would have preferred retaining the distinction between operating and financial lease for lessee. However, the majority of users (including valuation specialists) agreed with the current accounting treatment.

Auditors and NSS

- Application issues mainly refer to more judgmental areas, such are assessing whether a lease exists, the lease term and the discount rate;
- After the implementation phase, entities develop their own-practice and internal accounting policies to address the main issues;
- No need for fundamental changes;
- Additional and more detailed guidance for lessors might be useful (mirroring lessee approach).

WHAT WE LEARNT SO FAR?

APPLICATION ISSUES ARISING FROM THE IMPLEMENTATION OF IFRS 16

Main application issues

- **Identifying a lease** – difficulties in applying current requirement to:
  - Assess whether the lessee directs the use of the asset, including principal vs agent consideration and the assessment of the "substantially all economic benefits" concept;
  - Assess the lessor has substantive substitution rights;
  - Distinguish between lease and service contract ("embedded leases").
- **Low-value asset lease exemption** – the accounting may be burdensome (e.g., on aggregate basis these contract might not be material) and the application of the threshold of 5,000$ (IFRS 16, BC100) would not be consistent with the material assessment in IAS 1.
- **Separating lease and non-lease components** – in practice, the distinction between lease and a non-lease component may be difficult, especially in the renewable energy supply contracts (e.g., PPA) and in multi-components contract (e.g., provision of an asset plus ancillary services).
- **Determining lease term** – high level of judgment required and diversity in practice could exist (e.g., determining the non-cancellable period when an extension option or a tacit annual renewal option exist). Furthermore, lease contracts with similar economic substance but with different contractual terms might be accounted for considering different lease terms (e.g., contracts with indefinite lease term vs contracts with definite lease term without renewal option when the underlying asset is expected to be used for the same period of time)

WHAT WE LEARNT SO FAR?

APPLICATION ISSUES ARISING FROM THE IMPLEMENTATION OF IFRS 16

Main application issues

- **Accounting for contract modification**
  - Difficult to assess whether it represents or not a separate lease, especially when a modification would both increase and decrease the scope of the lease;
  - The accounting is too complex and burdensome, especially in those industries were modifications occurred frequently (e.g., retail).
- **Determining the lease payments**
  - Lack of clarity on current guidance to distinguish variable and in-substance fixed payments;
  - Accounting for some rent concession would not reflect the economic substance of the transaction (e.g., rent concessions vs lessor incentive for leasehold improvements made by the lessee);
  - Accounting for variable lease payment linked to an index when the updated index is not promptly available but has to be applied retrospectively. Lack of clarity on how to account for such adjustments to previous payments.
  - Accounting for variable lease payments in IFRS 16 is not consistent across IFRS Accounting Standards (e.g., IFRS 9 and IFRS 15) and between lease contracts and leaseback transactions with only variable payments (please refer to the IFRS 16 amendments issued in 2022 relating lease liability in a sale and leaseback here).

WHAT WE LEARNT SO FAR?

APPLICATION ISSUES ARISING FROM THE IMPLEMENTATION OF IFRS 16

Main application issues

- **Determining the discount rate** – current requirements are too theoretical, judgmental and obtaining data might be costly for preparers. Diversity in practice exists and it could impair comparability between similar contracts.
- **Non-monetary consideration** – IFRS 16 is silent on how to measure such a consideration that is part of the lease payment. Therefore, diversity in practice may exist (e.g., measurement at fair value as per IFRS 15 or at the discounted value as per IFRS 16 for cash consideration?)
- **Sale and leaseback transaction** –
  - Difficult to assess the transaction unit of account (e.g., when the seller-lessee leases back only part of the asset sold);
  - Lack of specific or additional guidance within IFRS 16 to assess whether the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale (e.g., when a sale contract includes a call option or when the leaseback including the extension options covers substantially all the remaining useful life of an asset)

QUESTIONS FOR EFRAG ACADEMIC PANEL

RECOGNITION, MEASUREMENT AND PRESENTATION REQUIREMENTS

- Q4 – Do you agree with the **application issue** arising from the application of IFRS 16 summarised from slide 19 to 21? Have you identified any additional application issue not yet identified by the EFRAG Secretariat?
- Q5 - In your view, do current accounting requirements for **sale and leaseback** and for **variable lease payments** provide a faithful representation in the financial statements that is useful for users of financial information? Is there any new evidence, are there new issues and arguments that were not discussed in the previous standard-setting process?
- Q6 – Some users expressed concerns about the presentation of leases outflows in the statement of cash flows. In your view, do current **presentation requirements for cash flows related to leases** result in entities providing useful information to users of financial statements?

WHAT WE LEARNT SO FAR?

ISSUES ARISING FROM THE INTERACTION WITH OTHER IFRSs

Interaction with other IFRS Accounting Standards – IFRS 9

- **Cash shortfalls used to measure ECLs under IFRS 9** – there is diversity in practice regarding the extent to which cash shortfalls should be considered in the calculation of ECL. The IFRS IC Agenda Decision of October 2022 on Lessor Forgiveness of Lease Payments (IFRS 9 and IFRS 16) created further uncertainty about what the boundaries of credit risk are – whether and how the expression "all cash shortfalls" used in the Appendix A of IFRS 9 to define credit loss should be interpreted within the scope of concessions from the lender due to financial difficulties of the borrower (e.g., whether it has to include all cash shortfalls or only credit-related ones).
- **Distinction between a lease modification (IFRS 16) and extinguishment of a lease liability (IFRS 9) arising from a rent concession** – commenting on the *Annual Improvements – Volume 11,* EFRAG highlighted that the proposed amendments to IFRS 9 would continue to not address the interaction between IFRS 9 and IFRS 16 when the extinguishment of a lease liability arises from a lease modification which only involve a change in the consideration paid.
- **Accrued operating lease income** – under IFRS 16 the accrued operating lease income is not subject to the IFRS 9 impairment requirements, even though such balances are similar in nature to contract assets that an entity recognises under its contracts with customer applying IFRS 15 (para 107), which requires an entity to assess a contract asset for impairment in accordance with IFRS 9 (para 2.1(b)(i)).

WHAT WE LEARNT SO FAR?

ISSUES ARISING FROM THE INTERACTION WITH OTHER IFRSs

Interaction with other IFRS Accounting Standards – IFRS 9

- **Unguaranteed residual value** – IFRS 16 (para 77) states that a lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued. It is not clear whether a lessor is required to exclude the unguaranteed residual value of the asset being leased under a finance lease from the measurement of ECL in accordance with IFRS 9. IFRS 16 does not provide guidance on whether the reduction in residual value should be reflected in finance lease income or impairment expense.
- **Presentation – interaction with lessor accounting** – IAS 1 (para 82(ba)) specifies that the impairment losses determined in accordance with IFRS 9 are presented in a separate line item. It is not clear whether a lessor is required to present impairment losses in profit or loss separately or a lessor is permitted to present those amounts within finance income and whether a lessor is required to present the 'net investment in the lease' including the ECL allowance or should the allowance be presented as a separate amount adjacent to the 'net investment in the lease'.

WHAT WE LEARNT SO FAR?

ISSUES ARISING FROM THE INTERACTION WITH OTHER IFRSs

Interaction with other IFRS Accounting Standards – IFRS 15

- **Sale and leaseback transaction** – difficulties in assessing if the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale. There is a lack of specific or additional guidance within IFRS 16 about how to make this assessment. Specifically the following challenges were noted:
  - presence of a call option and a renewal option allowing to extend the term to substantially equivalent to the remaining economic life;
  - determination of a unit of account, e.g., a sale of a four-floor building with one floor leased back;
  - sale at a point in time vs over time (construction or modification of the construction) and leaseback
- **Identifying components in lease contracts and scope** – challenges when splitting the operating income due to leasing under IFRS 16 and arrangement of operating services under IFRS 15. Similar challenges when assessing the contracts where it is difficult to make the distinction between the sale of an asset with deferred payments and a lease. Current requirements and interaction within the standards involve significant judgements leading to diversity in practice.

WHAT WE LEARNT SO FAR?

ISSUES ARISING FROM THE INTERACTION WITH OTHER IFRSs

Interaction with other IFRS Accounting Standards – IAS 16

- **The distinction between lease and in-substance purchase** contract is not clear under IFRS 16. Indeed, a lease contract which includes a purchase option at the end of the contract might be classified as a lease contract or as an in-substance purchase contract, regardless the purchase option is at fair market value or at a lower value.
- **Different level of certainty in assessing optional periods** (‘reasonably certain to exercise an extension option’ applying IFRS 16) and in determining the useful life (‘expected to be available for use by an entity’ applying IAS 16.6) => IAS 16 requires a lower level of certainty than IFRS 16. Consequently, applying this view a lessee might conclude that the useful life (and depreciation period) of the leasehold improvements is longer than the lease term of the related lease.
- **The definition of initial direct costs** in IFRS 16 is not consistent with those **costs directly attributable** to an asset as defined in IAS 16.17, even if the underlying assets are the same. Furthermore, IFRS 16 is silent on how to account for costs other than "initial direct costs" (e.g., costs incurred to bring the underlying asset at the lessee's location).

WHAT WE LEARNT SO FAR?

ISSUES ARISING FROM THE INTERACTION WITH OTHER IFRSs

Interaction with other IFRS Accounting Standards – IAS 36

- **The impairment test requirements under IAS 36** may be difficult to apply in conjuction with IFRS 16, especially when IFRS 16 causes a reduction in headroom. Indeed, while RoU assets are included in a CGU when testing the value in use ('VIU') and/or the fair value less costs of disposal ('FVLCD') is not always clear whether the related lease liabilities should be excluded. The IFRS IC in 2016 noted that IAS 36 requires the carrying amount of a recognised liability to be deducted from both the carrying amount of a CGU and the amount determined under VIU without the cash outflows associated with the liability (i.e., including the lease liabilities in the CGU would have a neutral impact on a VIU test) However, lack of clarity still remains for FVLCD models, since IAS 36 has limited guidance on using FVLCD as the recoverable amount for a CGU with a non-separable liability.

WHAT WE LEARNT SO FAR?

ISSUES ARISING FROM THE INTERACTION WITH OTHER IFRSs

Interaction with other IFRS Accounting Standards – IFRS 3

- **Remeasurement of the RoU and lease liability** at present value of the remaining lease payments at the date of acquisition as if the acquired lease was a new lease at acquisition date leads to different outcome compared to the measurement at inception of the lease contract. The treatment is different compared to owned PPE under IAS 16, measured at fair value in a business combination.

Interaction with other IFRS Accounting Standards – IFRS 10

- **Sale and leaseback of a single asset entity through corporate wrapper** - Analysing how the loss of control requirements in IFRS 10 interact with the sale and leaseback requirements in IFRS 16 in the context of a corporate wrapper may require further analysis. Indeed, the interaction is not, for example, explained in one sentence or through a cross-reference as it is in some other situations (e.g., derecognition requirement in IAS 16 and IAS 38). However, based on the discussion held at the IFRS IC in February 2021, the Committee recommended that the Board undertake narrow-scope standard-setting to address the submitted fact pattern and similar transactions. To date, we highlight that such a project is in the IASB pipeline project (here).

WHAT WE LEARNT SO FAR?

ISSUES ARISING FROM THE INTERACTION WITH OTHER IFRSs

Interaction with other IFRS Accounting Standards – Other

- IAS 29 – **Different translation requirements** between the RoU (non-monetary item) and the lease liability (monetary item) would lead to unbalanced presentation.
- IAS 37 – lack of clarity about which standard has to first apply in case of **onerous lease contracts**.
- IFRS 11 – Neither IFRS 11 nor IFRS 16 provide specific guidance on accounting for **leases in context of joint operations**. It may affect presenting information by operators on leased field assets in extractive industries (e.g., oilfields). A recent discussion at IFRS IC in March 2019 only dealt with the liability and not with the asset side of the lease and, therefore, there were issues on the way to portray some activities.

QUESTIONS FOR EFRAG ACADEMIC PANEL

RECOGNITION, MEASUREMENT AND PRESENTATION REQUIREMENTS

- Q7 - Do you agree with the application challenges arising from the **interaction between IFRS 16 and other IFRS Accounting Standards** summarised from slide 23 to 29? Have you identified any additional issue not yet identified by the EFRAG Secretariat?

OTHER TOPICS

- Q8 - Do you **have any additional input** about the impact of IFRS 16 and/or **any new evidence** not yet considered by the IASB when drafting IFRS 16 (e.g., new market conditions or new business models) that EFRAG should raise to the IASB during the PIR?
- Q9 - Do you have any remarks/**recommendations for the next steps** of the project?

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THANK YOU

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Financial reporting