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20 August 2019

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

By online submission: - www.ifrs.org

Dear Hans

Exposure Draft ED/2019/2 - Annual Improvements to IFRS Standards 2018-2020

CPA Australia represents the diverse interests of more than164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest. CPA Australia commends the IASB's continued efforts to improve IFRS and welcomes the opportunity to comment on this Exposure Draft (ED).

Our comments provided in this submission are limited to the proposed amendments to Illustrative Example 13 (IE 13) accompanying IFRS 16 *Leases*. CPA Australia is of the view that there is insufficient guidance and discussion for lessees around the accounting for lease incentives in IFRS 16 and accompanying material. We are concerned that this lack of guidance could give rise to inconsistent application of the requirements of IFRS 16 when accounting for lease incentives.

Following feedback from our members and other stakeholders, and based on our own observations, we wrote to the IFRS Interpretations Committee (IFRIC) in May 2019 requesting clarification on this matter. A copy of our letter is attached as an Appendix to this submission. We thank the IASB technical staff for speaking to us following our submission to IFRIC, and providing us with views and explanations on the matters raised. We believe it would be beneficial if the guidance and application material accompanying IFRS 16 is clarified and enhanced to reflect the understanding of the IASB and its technical staff on how lease incentives should be accounted for under IFRS 16.

The three issues relating to the accounting for lease incentives that we raised with IFRIC were:

- The requirements for the accounting for lease incentives in IFRS 16 are unclear and could give rise to inconsistent accounting treatments
- It is not clear whether the definition of lease incentives includes costs incurred by the lessee associated with leasehold improvements that are reimbursed by the lessor
- IFRS 16 does not set out the requirements/provide guidance on the accounting treatment for lease incentive balances brought forward at the date of transition to IFRS 16.

We have provided further details on the above matter in the Attachment to this letter. If you require further information on the views expressed in this submission, please contact Ram Subramanian, Policy Adviser – Reporting, on +61 3 9606 9755 or at ram.subramanian@cpaaustralia.com.au.

Your sincerely

Dr. Gary Pflugrath
Head of Policy and Advocacy

Attachment to CPA Australia's submission on Exposure Draft ED/2019/2

<u>Proposed amendment to Illustrative Examples accompanying IFRS 16 *Leases*</u>

Question

Do you agree with the Board's proposal to amend the Standards and accompanying documents in the manner described in the Exposure Draft? If not, why not, and what do you recommend instead?

As stated in our above cover letter, we have restricted our comments to the proposed amendments to IE 13 accompanying IFRS 16.

We acknowledge that the original wording of IE 13 has led to confusion and therefore support that need for amendments to guidance and other material accompanying IFRS 16. However, we consider that modifying IE 13 as proposed by simply eliminating references to leasehold improvements will not resolve the issue. Rather than eliminating the potential for confusion as suggested in the ED, we believe the proposed amendment will add to the confusion that already exists when lessees are accounting for lease incentives under IFRS 16.

Further details on the three issues identified in the above cover letter, and suggestions for guidance that may be developed to address these issues, follow:

The requirements for the accounting for lease incentives in IFRS 16 are unclear and could give rise to inconsistent accounting treatments

The definition of "lease payments" includes "…fixed payments less any lease incentives". This definition suggests that the term lease payments in IFRS 16 already excludes lease incentives. The requirements for calculating the right-of-use asset includes, in paragraph 24(b), "any lease payments made at or before commencement date, less any lease incentives received". Similarly, the requirements for calculating a lease liability includes, in paragraph 27(a), "fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable". We believe there is a technical inconsistency in the terminology used in the definition of lease payments, and the requirements in paragraphs 24(b) and 27(a), as the term "lease payments" used in these paragraphs should already exclude lease incentives. We suggest addressing this inconsistency through additional guidance or a discussion in the Basis for Conclusions. Subject to this, we offer the following comments on calculating the right-of-use asset and lease liability when lease incentives are involved:

<u>Lease incentives receivable subsequent to the commencement date</u>

If a lease incentive is receivable subsequent to the commencement date of the lease, the lessee accounts for the lease incentive as a deduction from the lease liability in accordance with paragraph 27(a). Since the starting point for the recognition of a right-of-use asset is the lease liability, a lower amount will be recognised for the right-of-use asset also. IFRS 16 and the accompanying guidance and other material do not currently provide for the accounting treatment when the lease incentive is subsequently received. The most common view we have identified from our discussions with stakeholders, which seemed to be also supported by the IASB technical staff, is that when the lease incentive is received it should be reflected as an increase in the lease liability. IASB technical staff have indicated that paragraph 36(b) addresses this accounting treatment, however we note that this paragraph states that "After the commencement date, a lessee shall measure the lease liability by… reducing the carrying amount to reflect the lease payments made…". The receipt of a lease incentive will result in an increase rather than a reduction in the carrying amount of the lease liability. While we believe a modification is required to the requirements in IFRS 16 to address this shortcoming, at the very least, we request the IASB develop and include an illustrative example that demonstrates how to account for lease incentives receivable subsequent to the commencement of the lease.

<u>Lease incentives received at or before the commencement date</u>

If a lease incentive is received at or before the commencement date of the lease, the lessee accounts for the lease incentive as a deduction from the right-of-use asset in accordance with paragraph 24(b). This would result in a higher lease liability compared to the right-of-use asset at commencement date. It could be considered that the higher lease liability at the commencement date represents an additional lease incentive liability that would have arisen if SIC 15

Operating Leases – Incentives (SIC 15) had been applicable. In paragraph 9 of the Basis for Conclusions (BC) to SIC 15, it is noted that "Payments made by a lessor to or on behalf of a lessee, or allowances in rental cost made by a lessor, as incentives for the arrangement of a new or renewed lease are an inseparable part of the net amount receivable or payable under the operating lease". Including an amended version of this statement in the Basis for Conclusions to IFRS 16 would assist in clarifying that the lease liability incorporates any lease incentives that may be agreed as part of the lease contract.

It is not clear whether the definition of lease incentives includes costs incurred by the lessee associated with leasehold improvements that are reimbursed by the lessor

In our submission to IFRIC, we sought clarification on whether the reimbursement by the lessor to the lessee for costs incurred in relation to leasehold improvements would meet the definition of lease incentives under IFRS 16. We note that paragraph 1 in SIC 15 states "Examples of such [lease] incentives are up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee)". During our discussions with IASB technical staff, they indicated that there was no intention to change, in IFRS 16, the previous recognition in SIC 15 that reimbursements or payments for leasehold improvements by the lessor to the lessee would be considered lease incentives.

Rather than clarifying the issue, we are concerned that the proposed amendments in the ED obfuscates the issue further. Referring to payments made by the lessor to the lessee towards the lessee's leasehold improvements in IE 13, paragraph BC2 to the ED states that "these payments did not meet the definition of lease incentives in IFRS 16 (that is, the payments were not associated with the lease and were not the reimbursement or assumption by the lessor of costs of the lessee, because, for example, the payments reimbursed the lessee for improvements made to the lessor's asset)". This statement appears to contradict the previous position under SIC 15 that payments by the lessor to lessee for leasehold improvements would meet the definition of lease incentives.

It is our view that payments made by the lessor to the lessee towards lessee's leasehold improvements would meet the definition of lease incentives, as was the case under SIC 15 and this seemed to be the view held by the IASB technical staff during our discussions with them. Accordingly, we request that the IASB amends IE 13 to establish this point and ensures clear guidance is provided on accounting for lease incentives relating to leasehold improvements.

IFRS 16 does not set out the requirements/provide guidance on the accounting treatment for lease incentive balances brought forward at that date of transition to IFRS 16

We request guidance on how to account for balances brought forward relating to lease incentives calculated under SIC 15, particularly when the modified approach to transition in accordance with paragraph C5(b) is adopted.

Where the modified approach under paragraph C8(b)(ii) is adopted (right-of-use asset equals lease liability) the right-of-use asset is "adjusted by the amount of any prepaid or accrued lease payments". Based on our discussions with IASB staff, we understand any lease incentive balances brought forward on the date of transition should be deducted from the right-of-use asset on this basis as such balances would meet the description of "the amount of any prepaid or accrued lease payments".

Where the modified approach under paragraph C8(b)(i) is adopted (right-of-use asset is calculated from the commencement date of the lease), we presume the right-of-use asset would also be adjusted for any lease incentives agreed at the commencement of the lease.

It would be helpful if the IASB issues guidance that clarifies the approach to accounting for lease incentives brought forward on commencement date.

Appendix

17 May 2019

IFRS Interpretations Committee
IFRS Foundation
Columbus Building
7 Westferry Circus
London E14 4HD
United Kingdom

By email: ifric@ifrs.org

Dear

IFRS 16 *Leases* – Seeking clarifications on accounting for lease incentives

CPA Australia represents the diverse interests of more than 164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

CPA Australia submits for consideration by the IFRS Interpretations Committee, a potential agenda item on the accounting for lease incentives by lessees under IFRS 16 *Leases* (IFRS 16). Prior to its replacement by IFRS 16, SIC 15 *Operating Leases – Incentives* (SIC 15) provided specific interpretations that clarified accounting for lease incentives for operating leases under IAS 17 *Leases* (IAS 17). Feedback from some of our members and our own observations have led us to the view that some clarifications and guidance are needed when accounting for lease incentives under IFRS 16. It is also our view that without some clarifications and guidance, inconsistent accounting treatments could arise when preparers seek to account for lease incentives under IFRS 16. We would like to highlight the following issues where clarification from the IFRS Interpretations Committee would be welcomed:

- **Issue 1 - Accounting for lease incentives under IFRS 16**
  For lessee accounting, IFRS 16 currently includes references to lease incentives in the requirements for measurement of the right-of-use asset, measurement of the lease liability and as part of the definition of lease payments. Based on the current definition(s) and requirements, it is not clear whether lease incentives should be excluded from the right-of-use asset, the lease liability, or both.
- **Issue 2 - Definition of lease incentives under IFRS 16**
  The definition of lease incentives includes the "reimbursement or assumption by a lessor of costs of a lessee". We seek clarification on whether such costs could include costs associated with leasehold improvements.
- **Issue 3 - Transitional accounting treatment of lease incentive balance brought forward**
  IFRS 16 does not prescribe the transitional accounting treatment for lease incentive balances previously measured under IAS 17/SIC 15. We welcome clarification of how to treat balances brought forward when transitioning to IFRS 16.

These three issues have been brought to our attention by our members who are in the process of implementing IFRS 16 within their organisations and based on our own observations of the requirements and guidance in IFRS 16.

Whilst the issues have been raised by Australian constituents we expect similar issues arising in other jurisdictions that have adopted IFRS including IFRS 16. We have also engaged in discussions about the issues with technical experts from various accounting firms during technical group meetings in Melbourne and Sydney. No clear and consistent responses were identified during these meetings, indicating diversity in interpretation of the application of IFRS 16 when accounting for lease incentives.

Diversity in accounting for lease incentives under IFRS 16 can undermine the aim of IFRS 16 to introduce better reporting of lease arrangements. Whilst IFRS 16 is seen as a significant improvement over IAS 17, the withdrawal of SIC 15 with no adequate replacement, will, in our view detract from the benefits IFRS 16 is expected to provide. Accounting for lease incentives was adequately addressed under SIC 15 and a similar interpretative approach to accounting for lease incentives under IFRS 16 will sufficiently address the issue.

Finally, we note that guidance on how to account for lease incentives under IFRS 16 is currently limited to Illustrative Example 13 – Measurement by a lessee and accounting for a change in the lease term (IE13). We note the IASB has a narrow-scope project to amend IE13 as part of its next annual improvements to IFRS standards. However, as far as we are aware, the three issues we describe in this letter are not currently being considered by the IASB as part of this project.

We have provided further details in the **Attachment** to this letter. If you require further information on the issues we have raised in this letter, please contact Ram Subramanian, Policy Adviser – Reporting, on +61 3 9606 9755 or at ram.subramanian@cpaaustralia.com.au.

Your sincerely

Dr. Gary Pflugrath
Head of Policy and Advocacy

Attachment

Issue 1 - Accounting for lease incentives under IFRS 16

For lessee accounting, IFRS 16 currently includes references to lease incentives in the requirements for measurement of the right-of-use asset, measurement of the lease liability and as part of the definition of lease payments. Based on the current definition(s) and requirements, it is not clear whether lease incentives should be excluded from the right-of-use asset, the lease liability, or both.

We note there are contrasting views on whether a lease incentive liability should be recognised under IFRS 16.

One view is that no lease incentive liability should be separately recognised as both the right-of-use asset and lease liability exclude the impact of the lease incentive (under IFRS 16). Also, the subsequent amortisation and interest expense charged to the income statement exclude the impact of any lease incentive. Another view is that the lessor will seek to recover any lease incentive through higher lease payments over the lease term, and this should be recognised as a lease incentive liability that is subsequently unwound over the lease term. This latter view reflects the previous position under SIC 15/IAS 17.

We envisage different accounting treatments by different preparers depending on how they interpret the requirements relating to lease incentives under IFRS 16.

We set out below two scenarios that reflect the latter view above, for accounting treatment based on Illustrative Example 13 – Measurement by a lessee and accounting for a change in the lease term (IE13). In presenting the two scenarios we have considered the lease incentive paid by the lessor to the lessee of CU5,000 towards real estate commission, but excluded CU7,000 paid by the lessor to the lessee towards lessee's leasehold improvements. We request the IFRS Interpretations Committee consider the different scenarios presented in addition to that presented in IE13 and provide clarification on the correct approach to accounting for lease incentives under IFRS 16.

Scenario A - Lease rentals of CU50,000 exclude the lease incentive (i.e. the lease payments of CU50,000 meet the definition of lease payment under IFRS 16)

Under this scenario, the rental under the lease agreement has been adjusted to exclude the effect of the lease incentive and the lease payment of CU 50,000 meets the definition of lease payment under IFRS 16. Consequently, the lease incentive will need to be separately accounted for in order for the general ledger to reflect the total rental payments under the lease agreement.

The following journals reflect the accounting entries if the lease payments exclude the effect of the lease incentive (immediately before the first lease payment):

Dr Right-of-use lease asset	405,391	
Cr Lease liability		405,391

This discounts CU50,000 for 10 years at 5%

Dr Cash	5,000	
Cr Lease incentive liability		5,000

This represents the lease incentive received, and the future "repayment" of that lease incentive through higher lease payments. Under this scenario, payments to the lessor are higher than the CU50,000.

Dr Right-of-use lease asset	15,000	
Cr Cash		15,000

This represents the payment for the initial direct cost of paying out the previous tenant

Dr Right-of-use lease asset	5,000	
Cr Cash		5,000

This represents the payment of the real estate commission by the lessee.

The combined journal entry based on the above would be:

Dr Right-of-use lease asset	425,391	
Cr Lease liability		405,391
Cr Lease incentive liability		5,000
Cr Cash		15,000

These entries do not match the combined entries in IE13.

Scenario B - Lease rentals of CU50,000 include the "repayment" of the lease incentive (i.e. the rental under the lease agreement)

Under this scenario, the lease payments are the lease rentals per the lease agreement. Therefore, the lease payments need to exclude the effect of the repayment of the lease incentive to meet the IFRS 16 definition. The lease incentive component is calculated at CU617 per year for 10 years at a 5% discount rate. This is a separate calculation.

When excluding lease incentives, IFRS 16 is not clear whether the amount to be excluded is inclusive or exclusive of implicit financing costs. Under this scenario CU6,170 is excluded from the gross lease rental payments, and not the present value of the lease incentive repayments of CU5,000.

Under this scenario, the lease payments under IFRS 16 would be CU50,000 less CU617 = CU49,383.

The following journals reflect the accounting entries if the lease payments include the effect of the lease incentive (immediately before the first lease payment):

Dr Right-of-use lease asset	400,389	
Cr Lease liability		400,389

This discounts CU49,383 for 10 years at 5% (CU50,000 less CU617)

Dr Cash	5,000	
Cr Lease incentive liability		5,000

This represents the lease incentive received, and the future "repayment" of that lease incentive through higher lease payments. This discounts CU617 for 10 years at 5%

Dr Right-of-use lease asset	15,000	
Cr Cash		15,000

This represents the payment for the initial direct cost of paying out the previous tenant

Dr Right-of-use lease asset	5,000	
Cr Cash		5,000

This represents the payment of the real estate commission by the lessee.

The combined journal entry based on the above would be:

Dr Right-of-use lease asset	420,389	
Cr Lease liability + incentive		405,389
Cr Cash		15,000

While the above entries match the combined entries in IE13, they are inconsistent with IFRS 16 which excludes lease incentives from the lease asset and the lease liability (through the definition of lease payments) as the balances above include lease incentives.

Right of use asset is CU420,389 being:

Discounted lease payments	400,389
Initial direct costs – payout of previous tenant	15,000
Lease incentive - Initial direct costs: real estate commission	5,000

Lease liability is CU405,389 being

Discounted lease payments	400,389
Lease incentive - Initial direct costs: real estate commission	5,000

Further, the approach in IE13 would not appear to work for fit-out costs with a different useful economic life to the right-of-use asset, which would need to be a separately identified asset (from the right-of-use asset) in the asset register for depreciation purposes.

Issue 2 - Definition of lease incentives under IFRS 16

The definition of lease incentives includes the "reimbursement or assumption by a lessor of costs of a lessee". We seek clarification on whether such costs could include costs associated with leasehold improvements.

SIC 15 paragraph 1 states "Examples of such incentives are up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee)".

The terminology in IFRS 16 and SIC 15 referred to above is similar, but SIC 15 provides specific examples of costs that can be considered as lease incentives, including leasehold improvements. Although the terminology used in IFRS 16 and SIC 15 is similar IE13 states "Lessee accounts for the reimbursement of leasehold improvements from Lessor applying other relevant Standards and not as a lease incentive applying IFRS 16". This appears to suggest that the reimbursement from lessor to lessee for leasehold improvement costs are not lease incentives.

A further issue on which we seek clarification relates to the economic benefit arising from the leasehold improvements that are paid for or reimbursed by the lessor. In some cases, the lessee enjoys the entire economic benefits arising from the leasehold improvement over the lease term but in other cases the leasehold improvement reverts to the lessor at the end of the lease term and the lessor enjoys the remaining economic benefit arising from the leasehold improvements. If costs associated with leasehold improvements that are paid for or reimbursed by the lessor are considered lease incentives, we seek clarification on the accounting for such lease incentives in the circumstances where the economic benefits arising could be enjoyed by the lessee, or by both lessee during the lease term and then subsequently by the lessor.

We request the IFRS Interpretations Committee considers providing some clarification for the accounting for transactions under IFRS 16 in relation to leasehold improvements.

Issue 3 - Transitional accounting treatment of lease incentive balance brought forward

IFRS 16 does not prescribe the transitional accounting treatment for lease incentive balances previously measured under IAS 17/SIC 15. We welcome clarification of how to treat balances brought forward when transitioning to IFRS 16.

Feedback we have received suggests two possible approaches to the accounting for lease incentive balances brought forward:

Approach 1

Any lease incentive balance brought forward should be adjusted against the right-of-use asset. This approach is based on paragraph C8(b)(ii) which states that a right-of-use asset is measured at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application. This approach assumes the modified transitional approach prescribed in paragraph C8(b) is adopted. It also assumes that lease incentive balances brought forward are akin to an “amount of any prepaid or accrued lease payments relating to the lease”.

Approach 2

Any lease incentive brought forward should be adjusted against retained reserves in accordance with paragraph C7.

We request the IFRS Interpretations Committee considers providing some clarification for the accounting for transactions under IFRS 16 in relation to lease incentive balances brought forward.