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<u>Comments on the Post-implementation Review of IFRS 16 *Leases*</u>

Dear Madam, dear Sir,

On behalf of the Austrian Financial Reporting Advisory Committee (AFRAC), the privately organised standard-setting body for financial and other corporate reporting in Austria, we appreciate the opportunity to comment on the Post-implementation Review of IFRS 16 *Leases*.

Principal authors of this comment letter were Erich Kandler (chair), Helmut Kerschbaumer and Verena Nitschinger. In order to ensure a balanced Austrian view on the consultation, these authors have different professional backgrounds.

Best regards,
Romuald Bertl
Chairman

<u>Comments on the Post-implementation Review "IFRS 16 *Leases*"</u>

Question 1 — Overall assessment of IFRS 16

(a) In your view, is IFRS 16 meeting its objective (see page 9) and are its core principles clear? If not, please explain why not.
(b) In your view, are the overall improvements to the quality and comparability of financial information about leases largely as the IASB expected? If your view is that the overall improvements are significantly lower than expected, please explain why.
(c) In your view, are the overall ongoing costs of applying the requirements and auditing and enforcing their application largely as the IASB expected? If your view is that the overall ongoing costs are significantly higher than expected, please explain why, how you would propose the IASB reduce these costs and how your proposals would affect the benefits of IFRS 16.

The Effects Analysis on IFRS 16 describes the expected likely effects of the Standard, including benefits and implementation and ongoing costs.

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

AFRAC's response to Question 1:

ad a)
AFRAC considers that IFRS 16 *Leases* ('IFRS 16') is generally working well and has largely achieved its objective of ensuring that lessees and lessors provide relevant information about their lease contracts in a manner that faithfully represents rights and obligations resulting from these contracts.

Major changes introduced by IFRS 16 affected the lessee accounting solely, which is why the lessor accounting received less attention from users, preparers, and other stakeholders. From a user's perspective, the changes introduced by IFRS 16 for lessees, resulting in an on-balance sheet accounting for most leases, lead to an increase in transparency and comparability of lease-related financial information as compared to IAS 17 *Leases* ('IAS 17'). Some preparers, however, argue that the perceived benefits brought by the changes in the lessee accounting may not outweigh the significant implementation and ongoing costs and efforts.

Besides the fact that IFRS 16 is generally working well and largely meeting its objectives, AFRAC sees some potential for narrow-scope amendments as highlighted in our responses below.

ad b)
In AFRAC's view, the improvements to the quality and comparability of lease-related financial information are visible and broadly meet expectations, although a few limitations remain. Removing the distinction between finance and operating leases for lessees results in most leases being recognised on-balance-sheet, which brings greater transparency about lease contracts and related financial obligations. When transitioning from IAS 17 to IFRS 16, preparers had to comprehensively review their leasing models that, in many cases, turned out to be remarkably diverse with respect to the calculation of lease payments, cancellation periods or rights to transfer. As a result, AFRAC

observes significant learning effects and, in some cases, clearer internal control and guidance within companies. Comparability has improved by requiring most leases to be recognised on the balance sheet as this facilitates comparing leases with the purchase of assets. In substance, the changes introduced by IFRS 16 also positively affect comparability to the corresponding topic under US GAAP (Topic 842), even though some differences remain. However, some areas require a significant level of judgement, such as identifying a lease, determining the lease term or the applicable interest rate, which may lead to diversity in practice and may impact comparability.

ad c)
Overall, AFRAC considers the overall ongoing costs of applying the requirements under IFRS 16 substantially as expected. These costs mainly result from the need to continuously update lease data, assess complex lease modifications and reassessments. Especially in lease-intensive entities and industries, the ongoing costs may exceed the IASB's initial expectations. Narrow-scope amendments, such as outlined below may reduce complexity and costs without reducing benefits at the same time. The comparison of the costs of implementing and maintaining IFRS 16 to the previous standard should also be based on the aspect that one should consider the need to maintain a fixed asset register and to account for the debt incurred when purchasing an asset outright instead of just looking at the cost of accounting for periodical lease payments only because this is of a completely different economic substance.

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

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

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

(c) If your view is that the IASB should improve the usefulness of financial information resulting from lessees' application of judgement, please explain:
   - *(i) what amendments you propose the IASB make to the requirements (and how the benefits of the solution would outweigh the costs); or*
   - *(ii) what additional information about lessees' application of judgement you propose the IASB require entities to disclose (and how the benefits would outweigh the costs).*

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

AFRAC's response to Question 2:

ad a)
The major changes introduced by IFRS 16 were viewed as positive changes, leading to an increase in quality, transparency and comparability of lease-related financial information. However, some areas require a significant level of judgement that AFRAC considers resulting in diversity in practice, which may impact comparability.

ad b) & c):
In accordance with IAS 17, lessees had to classify a lease as either finance or operating with distinct accounting requirements. AFRAC notes that this distinction had been straightforward for standard lease contracts. However, preparers encountered challenges when lease contracts had been more complex, leading to diversity in practice. When transitioning from IAS 17 to IFRS 16, the distinction between finance and operating leases and the complexity associated with it have been eliminated. However, applying the new lease standard has shown that the determination of a transaction to fall within the scope of IFRS 16 or not has now become one of the main application issues. Especially the distinction between leases and service contracts may be difficult and may involve a significant level of judgement. For example, the use of power purchase agreements ('PPA') for the supply of renewable energy has become quite common in the last few years. Even though PPAs do not take the legal form of a lease, these arrangements may convey the right to control the use of an identified asset for a period of time in exchange for consideration, thereby fulfilling the definition of a lease. Preparers note that this assessment is often complex and involves a significant level of judgement, leading to diversity in practice. AFRAC therefore recommends the IASB to provide either additional application guidance and illustrative examples or - based on the issues identified when applying IFRS 16 so far - expand and clarify existing examples to support the identification of a lease. The significant level of judgement involved in identifying a lease may, however, also open up structuring opportunities for entities. In AFRAC's view, some level of judgement is considered as reasonable as long as it allows to account for PPAs or similar arrangements in accordance with their actual economic substance.

AFRAC notes some complexity in determining lease term, especially the non-cancellable period, for example if options to extend the lease exist or contracts have indefinite lives and little termination notice periods. In these cases, the determination of the lease term significantly depends on the management's judgement, leading to diversity in practice. This significant level of judgement involved in determining the lease term may also open up structuring opportunities for companies. Lease contracts with different contractual terms can be negotiated that have to be presented differently in the financial statements, even though these contracts are, in substance, economically the same. The non-cancellable period of a lease contract with an indefinite life may differ from a contract with a definite life with or without extension options. As long as the lease period of a lease contract represents the best possible estimate, AFRAC considers the level of judgement in the determination of the lease term as reasonable. However, AFRAC recommends the IASB to provide additional application guidance and illustrative examples (or improve existing examples) to support the definition of the non-cancellable period based on the past experience gained from applying IFRS 16, thereby reducing diversity in practice and increasing comparability.

As aforementioned, there is a significant level of judgement involved in the determination of the lease term. As long as the lease period of a lease contract represents the best possible estimate, AFRAC considers this level of judgement as reasonable. In light of this, AFRAC views para. 5(a) of IFRS 16, which allows preparers to exempt short-term leases, i.e., a lease that, at the commencement date, has a maximum possible term of 12 months or less, from recognition according to para. 22 to 49 of IFRS 16, as rather critical. AFRAC understands the rationale behind the IASB's conclusion to provide lessees some relief by arguing that the benefits of applying all of the requirements in IFRS 16 to these leases do not outweigh the associated costs. However, AFRAC notes that, on the one hand, the preparer's decision to apply the recognition exemption is not always based on the best possible estimate of the (economic) minimum non-cancellable lease term. This, even though, the determination of the duration of short-term leases has to be made consistent with the determination method of the lease term of other leases, e.g., including extension options being reasonably certain to be exercised. In order to address the risk that leases may be structured to meet the short-term lease exemption, AFRAC recommends the IASB to provide additional application guidance and illustrative examples to support the recognition exemption for short-term leases.

On the other hand, AFRAC supports a notion to allow the short-term exemption to be also used beyond the current 12-month period if the criteria of a normal business (or operating) cycle of more than 12 months are met (see IAS 1.68). Typically, such lease arrangements are designed to last for the duration of specific projects (for example machinery leased for a specific construction project exceeding one year) but not beyond it. This can be accomplished by simply adjusting the definition in the Basis for Conclusion, para. 91 to 97 of IFRS 16, to reflect the extended definition of short-term. Additionally, the decisions taken on the short-term leases impacts the presentation in the Cash-Flow statement (see Q3 below).

In AFRAC's view, the determination of the discount rate for the initial measurement of the lease liability represents another main application issue. According to para. 26 of IFRS 16, lease payments shall primarily be discounted using the interest rate implicit in the lease, unless that rate cannot be readily determined, then preparers shall use their incremental borrowing rate ('IBR'). However, AFRAC notes that lessees often face difficulties in determining the interest rate implicit in the lease since that rate is generally also affected by other factors only known to the lessor (such as the amount to be amortized over the lease term), which is why lessees primarily apply the IBR instead of the interest rate implicit in the lease. The determination of the IBR is often perceived as complex and involves a significant level of judgement since factors like the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs have to be taken into account. This leads to the application of substantially different discount rates across entities, which may impact comparability. To address the aforementioned, AFRAC recommends the IASB that the interest rate implicit in the lease and the IBR shall be considered as equivalent interest rates for the initial measurement of the lease liability. Besides, additional application guidance and illustrative examples may support the determination of the IBR. AFRAC notes that an overall solution to the issues around consistently determining interest rates for the various purposes is still outstanding and suggests (again) to address the matter at an overall level similarly to IFRS 13 for fair values.

According to para. 27(b) of IFRS 16, the initial measurement of the lease liability only comprises variable lease payments that depend on an index or a rate. AFRAC, however, notes that the relevance of variable lease payments that do not depend on an index or rate, e.g., sales-based variable lease payments, increased steadily. These variable lease payments may provide greater flexibility, higher premiums and other benefits for both lessees and lessors. However, not taking these payments into accounting may have significant effects on the recognition of lease liabilities and right of use assets. In addition, AFRAC notes that the accounting for variable lease payments in IFRS 16 is not consistent with other IFRS Accounting Standards. For instance, according to para. 53 of IFRS 15, preparers have to consider variable considerations based on their best possible estimate. AFRAC therefore recommends the IASB to assess whether the relevance of information provided about leases and related financial obligations is likely to increase when additional types of variable considerations are included based on the best possible estimate when determining the lease liability and consequently the right of use asset. Together, this will better reflect the economic substance of a lease transaction involving non-index or non-rate linked variable payments. The above should also be applied to para. 36 to 43 of IFRS 16, which is dealing with the subsequent (re)measurement of lease liabilities.

Question 3 — Usefulness of information about lessees' lease-related cash flows

Do you agree that the improvements to the quality and comparability of financial information about lease-related cash flows that lessees present and disclose are largely as the IASB expected? If your view is that the improvements are significantly lower than expected, please explain why.

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

AFRAC's response to Question 3:

Overall, AFRAC observes that the transparency of cash flows arising from lease contracts has improved compared to the prior reporting under IAS 17. Nevertheless, as highlighted in Spotlight 3, the segregation of lease payments into principal (financing activities), interest (classified as either operating or financing activities depending on the accounting policy choice), and payments related to variable or short-term lease components (operating activities) continues to limit transparency. The disclosures required in the notes do not fully mitigate this limitation.

Accordingly, AFRAC recommends that the IASB consider measures to further enhance transparency, for example by specifying the requirements for the disclosure of significant non-cash transactions (para. 43 of IAS 7). Such disclosures should be presented either directly in the cash flow statement or in the notes to the cash flow statement — rather than elsewhere in the financial statements — and should include a breakdown of the amounts that would have been classified as investing or financing activities as if the transactions would have been executed in cash.

Furthermore, AFRAC suggests that the disclosure of total lease payments (para 53(g) of IFRS 16) could be enhanced by requiring a presentation of the components reflected in the cash flow statement, specifically principal, interest, and operating components.

Question 4 — Ongoing costs for lessees of applying the measurement requirements

(a) *Do you agree that the ongoing costs of applying the measurement requirements in IFRS 16 are largely as the IASB expected? If your view is that the ongoing costs are significantly higher than expected, please explain why, considering how any entity-specific facts and circumstances (such as IT solutions) add to these costs.*

(b) *If your view is that the ongoing costs are significantly higher than expected, please explain how you propose the IASB reduce these costs without a significant negative effect on the usefulness of financial information about leases.*

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

AFRAC's response to Question 4:

ad a)
We observe that the ongoing costs of applying the measurement requirements of IFRS 16 can generally be managed when entities make appropriate use of the available reliefs, such as the exemptions for short-term or low-value leases. In such cases, the costs appear broadly in line with the IASB's expectations and are balanced against the benefits of the standard.

At the same time, several aspects of the requirements continue to create notable challenges in practice. These include the reassessment of lease liabilities following contractual changes, the operational burden of dealing with index- or rate-linked lease payments, and the determination of the discount rate. In particular, industries with large and complex lease portfolios are affected, as frequent remeasurements and the associated manual processes often lead to significant ongoing costs without a commensurate improvement in the quality of information.

ad b)
If ongoing costs are perceived as higher than expected, the IASB could consider targeted measures to ease the application burden without reducing the usefulness of lease information:

- Discount rate determination: Stakeholders often describe the determination and update of the incremental borrowing rate as complex and resource intensive. Providing additional clarity on acceptable approaches could help reduce the effort involved.
- Lease modifications: Reassessments triggered by contractual changes in large lease portfolios create recurring costs. Simplified requirements for frequently occurring modifications could improve the cost-benefit balance.
- Index- and rate-linked lease payments: Adjustments resulting from changes in indices or interest rates are operationally demanding. Practical guidance on how to address delays in index availability may help to reduce costs.
- Immaterial leases: The effort required to monitor numerous immaterial contracts is often disproportionate to their relevance. Extending the existing exemptions could mitigate this burden.

Question 5 — Potential improvements to future transition requirements

Based on your experience with the transition to IFRS 16, would you recommend the IASB does anything differently when developing transition requirements in future standard-setting projects? If so, please explain how your idea would ensure:

(a) users have enough information to allow them to understand the effect of any new requirements on entities' financial performance, financial position and cash flows; and
(b) preparers can appropriately reduce their transition costs when implementing new requirements for the first time.

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

AFRAC's response to Question 5:

The modified retrospective approach is in general not a preferred way forward although certain standards (such as IFRS 3 and potentially IFRS 19) warrant the modified method. The full retrospective method is generally considered more appropriate, in our view. In practice, the modified retrospective method was a relevant exception for IFRS 15 and IFRS 16, where it was practically and also politically necessary to facilitate the first-time adoption.

Regarding the Exposure Draft on Improvements, a possible solution could be to require retrospective application as the baseline, while allowing for specific exceptions - for example, for contracts that are close to the expiry date.

Question 6.1 — Applying IFRS 16 with IFRS 9 to rent concessions

(a) How often have you observed the type of rent concession described in Spotlight 6.1?
(b) Have you observed diversity in how lessees account for rent concessions that has had, or that you expect to have, a material effect on the amounts reported, thereby reducing the usefulness of information?
(c) If your view is that the IASB should act to improve the clarity of the requirements, please describe your proposed solution and explain how the benefits of the solution would outweigh the costs.

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

AFRAC's response to Question 6.1:

This relates to Covid and the question of how to deal with such situations now that the pandemic has passed. It was a special case, handled through temporary relief measures, and the focus is now on how to treat these cases going forward.

Question 6.2 — Applying IFRS 16 with IFRS 15 when assessing whether the transfer of an asset in a sale and leaseback transaction is a sale

(a) How often have you observed difficulties in assessing whether the transfer of an asset in a sale and leaseback transaction is a sale?
(b) Have you observed diversity in seller–lessees' assessments of the transfer of control that has had, or that you expect to have, a material effect on the amounts reported, thereby reducing the usefulness of information?
(c) If your view is that the IASB should act to help seller–lessees determine whether the transfer of an asset is a sale, please describe your proposed solution and explain how the benefits of the solution would outweigh the costs.

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

AFRAC's response to Question 6.2:

Sale and leaseback transactions are very tightly regulated. They typically occur in restructuring or refinancing situations, often when hidden reserves are realised to finance another major project.
A possible solution could be to ease the current requirements by focusing more on appropriate presentation and disclosure, rather than strict recognition criteria.

Question 6.3 — Applying IFRS 16 with IFRS 15 to gain or loss recognition in a sale and leaseback transaction

(a) Do you agree that restricting the amount of gain (or loss) an entity recognises in a sale and leaseback transaction results in useful information?
(b) What new evidence or arguments have you identified since the IASB issued IFRS 16 that would indicate that the costs of applying the partial gain or loss recognition requirements, and the usefulness of the resulting information, differ significantly from those expected?
(c) If your view is that the IASB should improve the cost–benefit balance of applying the partial gain or loss recognition requirements, please describe your proposed solution.

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

AFRAC's response to Question 6.3:

There is no agreement with the idea of restricting the recognition of gains or losses. A more appropriate approach would be to allow full recognition and address concerns through comprehensive disclosures.

Question 6.4 — Other matters relevant to the assessment of the effects of IFRS 16

Are there any further matters the IASB should examine as part of the post-implementation review of IFRS 16? If so, please explain why, considering the objective of a post-implementation review as set out on page 5.

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

AFRAC's response to Question 6.4:

It has been observed that certain structuring opportunities (such as the right to exchange the leased assets by the lessor and the situations referred to in Q 2 above) have been identified by market participants that may lead to unintended consequences. Most of them are based on extensive interpretation of standards and should not become commonplace. AFRAC suggests that the IASB closely monitors such developments and prepares position papers etc that help to mitigate the impact of certain structuring arrangements.

Apart from that, there are no specific areas that AFRAC has identified which would require further investigation by the IASB.