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Our ref BOD/288

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Dear Dr Barckow

Comment letter on Request for Information Post-implementation Review — IFRS 16 Leases

We appreciate the opportunity to comment on the International Accounting Standards Board's (the IASB's) Request for Information Post-implementation Review — IFRS 16 Leases. We have consulted with, and this letter represents the views of, the KPMG network.

We believe that IFRS 16 is generally working as intended and does not require significant amendment. IFRS 16's core principles provide an appropriate basis for lease accounting decisions that result in useful information about an entity's contracts. The accounting standard has largely achieved its objective of improving financial reporting in this area.

Our overall impression is that the initial costs of implementing the accounting standard were high for some entities. However, the ongoing costs are outweighed by the benefits to users of the financial statements from the improved financial information provided.

We believe that the Request for Information has appropriately identified some of the most common application issues. However, we have identified other areas for which additional clarification could be helpful. We have listed below, in order of priority, the areas for which we believe further guidance would help to reduce diversity in practice:

- the interaction between IFRS 16 and IFRS 9 *Financial Instruments*;
- lessee involvement with the underlying asset before lease commencement;
- variable lease payments that are intermittent throughout the lease term;
- differences in the accounting models for variable payments in IFRS 16 and IFRS 15 *Revenue from Contracts with Customers*;
- lessor accounting for certain leases with fully or mostly variable lease payments;
- measurement of non-monetary consideration; and

- discount rates in highly inflationary jurisdictions.

The interaction between IFRS 16 and IFRS 9

We consider that the amendment to paragraph 2.1(b)(ii) of IFRS 9, made by the IASB as part of the *Annual Improvements to IFRS Accounting Standards*, has not resolved the conflict between the requirements of IFRS 16 and IFRS 9 for modifications that do not involve changes to the lease contract other than the forgiveness of specifically identified lease payments. As a result, it remains unclear whether the lessee should apply the requirements in IFRS 9 or IFRS 16.

We recommend the IASB undertake a narrow-scope project to clarify the distinction between lease modifications and extinguishments. Our own suggestion would be to bring all modifications that meet the IFRS 16 definition of a lease modification entirely, and exclusively, in the scope of IFRS 16.

Lessee involvement with the underlying asset before the commencement date

We suggest that the IASB adds guidance on how lessees should assess whether they control an asset before lease commencement, in line with paragraph B46 of IFRS 16. This issue is raised regularly in practice across multiple jurisdictions and can be significant when it occurs; however, there is currently little guidance in IFRS 16 for entities to apply. We believe it would be helpful to consider adding the factors in paragraph 842-40-55-5 of US GAAP; this would also enhance convergence between the two frameworks for an important class of transactions.

Variable lease payments

We believe that the initial implementation challenges relating to variable lease payments have largely been resolved and the requirements in this area are working well overall. However, there remain areas for which we believe the IASB can improve the clarity of the requirements.

Firstly, we believe that differences in interpretation of the words “...become fixed for the remainder of the lease term” in paragraph B42(a)(ii) of IFRS 16 result in diversity in practice when lease payments are initially variable and become fixed for a period of time, before reverting to being variable.

Secondly, the interaction between IFRS 15 and IFRS 16 when measuring and allocating consideration between lease and non-lease components can lead to significant differences in accounting outcomes.

Lessor accounting

We appreciate that when the IASB was finalising IFRS 16, its view was that lessor accounting should not be amended. However, we believe that IFRS 16’s greater guidance on lessee accounting has led to increased attention on lessor accounting as well. This has highlighted a number of gaps in the current framework for lessor accounting, and there are certain improvements that could be made, as follows.

- How to deal with unguaranteed residual values, particularly when there is a change to the lease term as a result of either a modification or the lessee exercising an option. This is a common issue in many jurisdictions.
- Situations in which a lessor has a finance lease with fully or mostly variable payments, or a head lease (as a lessee) with fully or mostly variable payments and a sub-lease that is classified as a finance lease with fixed payments for the same term as the head lease. We believe that the current IFRS 16 requirements can lead to an inappropriate accounting outcome in some scenarios, with a gain or loss recorded in the statement of profit or loss on lease commencement. We suggest the IASB adopt a similar approach to US GAAP, where an amendment was made to preclude this happening by classifying such leases as operating leases.

Non-monetary consideration

Many lease agreements include non-monetary consideration. Our presumption is that such consideration should be measured at fair value, although this is not specified in the accounting standard. More guidance on the measurement of non-monetary consideration would be useful, particularly in relation to whether the initial fair value should be derived by reference to the gross value of the estimated future payments based on today's spot values and then discounted back, or using forward rates (i.e. with no discounting).

Discount rates

IFRS 16's use of a nominal discount rate, whilst lease payments are not adjusted for future inflation, has been criticised in jurisdictions subject to high inflation for resulting in inappropriate measurement of lease liabilities. To resolve this, we believe that the IASB could add guidance on how to determine an appropriate discount rate for entities to use when all lease payments are linked to the Consumer Price Index (CPI) in such jurisdictions.

Structure of our letter

Appendix A to this letter contains our detailed responses to the questions raised in the Request for Information.

Appendix B includes other matters that we have observed in our experience. Whilst we view them as a lower priority than the points we have raised in Appendix A, we nevertheless believe that the IASB should still consider them in its review.

Appendix C details an example scenario to illustrate our response to Question 2 relating to variable lease payments.



Please contact Brian O'Donovan at brian.odonovan@kpmgifrg.com or Kimber Bascom at kbacom@kpmg.com if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

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Appendix A – KPMG’s responses to the specific questions raised in the Request for Information

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.

In our view, IFRS 16 is generally meeting its objective of ensuring that lessees and lessors provide relevant information about their leases in a manner that faithfully represents those transactions. IFRS 16’s core principles are clear and provide an appropriate basis for lease accounting decisions to be made, which results in useful information being reported in an entity’s financial statements.

Considering this, we do not believe that major changes to IFRS 16 are needed, especially because they would likely require entities to incur significant further costs changing their existing lease accounting systems and modifying established processes and internal controls. However, there are certain areas for which additional clarification could be helpful. We discuss these in more detail in our responses to Questions 2–6.4 below.

Although we have not collected any specific information on costs, our perception is that the initial costs of implementing the new accounting standard were high for some entities. Ongoing costs post-transition, whilst still significant in some areas, such as modification accounting, have been much less. Whilst preparers are likely to be best placed to respond to questions regarding costs, our overall impression is that the accounting standard strikes an appropriate balance between the costs of application and the benefits for users that result from them.

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.

We believe that the usefulness of information resulting from the lessees’ application of judgement is primarily an issue for users to comment on. Our impression though is that IFRS 16 generally provides a clear and sufficient basis for entities to make appropriate judgements and results in useful information. However, from our experience, we have identified certain areas in which the accounting standard could be improved to provide more useful information. We set these out below.

Lease term

In general, the requirements in IFRS 16 provide a clear and sufficient basis for entities to make appropriate judgements in relation to the lease term. Whilst the determination of the lease term involves some complex judgements, after the initial transition period, our observation is that this has not been particularly problematic in practice.

However, one area that continues to be challenging is the determination of the non-cancellable period when it becomes fixed only after lease commencement. For example, when an entity leases an asset to use on a specific project and the lease states that the period of use is for the duration of the project (or extends for a defined term following completion of the project), there is currently no guidance in IFRS 16 as to what the initial lease term should be and whether and how the lease term should be revised when the non-cancellable period becomes fixed after lease commencement. We suggest that the IASB includes additional material to assist entities in determining the lease term for such scenarios.

Discount rates

There are some complex areas of judgement in determining discount rates; however, in our experience after some initial implementation challenges in the transition period to the new accounting standard, this has not been a particularly problematic area in practice.

In general, we believe that the usefulness of information is largely as the IASB expected when IFRS 16 was implemented. However, we note that in certain jurisdictions there has been specific criticism relating to IFRS 16 requiring use of a nominal discount rate whilst lease payments are not adjusted for future inflation, because this may lead to the lease liability not reflecting the underlying economics of the arrangement and future volatility in the statement of profit or loss. This is especially pertinent for countries experiencing high levels of inflation. To resolve this, we believe that the IASB could consider adding guidance on how to determine an appropriate discount rate for entities to use when all lease payments are linked to CPI in highly inflationary jurisdictions.

Variable lease payments

Our perception is that the usefulness of information resulting from the lessee's application of judgement in relation to variable lease payments is largely as expected.

In general, the requirements in IFRS 16 provide a clear and sufficient basis for entities to make appropriate judgements when accounting for variable lease payments.

Overall, we have not encountered significant challenges in determining the type of variable lease payments to be included in the lease liability. However, we are aware of specific areas where judgement needs to be exercised in determining variable lease payments.

Firstly, we believe that there is some complexity when determining the boundary point between variable lease payments and payments that are initially variable but become in-substance fixed payments when the variability is resolved. We continue to receive queries about how to interpret the meaning of the words '*...become fixed for the remainder of the lease term*' in paragraph B42(a)(ii) of IFRS 16. We have seen two instances of this issue which have been particularly problematic in practice:

- *leases with co-tenancy clause*: how to determine whether lease payments are fixed or variable in a lease with a co-tenancy clause, under which the lessee's fixed payments will be reduced and replaced with variable payments if an anchor tenant leaves and the fixed payments revert to their previous amount when a new anchor tenant occupies the vacant space; and
- *leases in which payments that are initially variable become fixed when the variability is resolved*: in situations in which lease payments periodically become fixed for a short period of time (e.g. if payments for the next year are based on the prior year's sales, but remain at that point variable for future years), treating those payments as in-substance fixed payments results in a right-of-use ('ROU') asset being gradually

built up over time, which in turn leads to a backloaded ROU asset depreciation profile in the statement of profit or loss. See Appendix C to our letter for an illustration of this point.

It is not clear whether the IASB's intention was to remeasure the lease in such scenarios. We suggest that the IASB includes an example or amendment to paragraph B42(a)(ii) of IFRS 16 to clarify this.

Secondly, regarding the interaction between IFRS 15 and IFRS 16 in relation to variable lease payments, there remains uncertainty about how to measure and allocate the pool of consideration when a revenue contract contains a lease component and one or more additional lease or non-lease components. We note that US GAAP has a definition of consideration in the contract in this context and suggest the IASB consider whether that definition would clarify this issue and whether alignment in this area would be beneficial.

When the contract contains an optional renewal period, it is not clear whether to measure and allocate the consideration based on the lease term as determined under IFRS 16 (i.e. including optional renewal periods when the lessee is reasonably certain to extend) or based on the contract term as determined under IFRS 15 (i.e. only including periods during which the parties have presently enforceable rights and obligations).

In addition, it is not clear whether the allocation guidance in IFRS 15 for changes in the transaction price also applies to the lessor's reallocation on remeasurement of the lease payments when there is a change in the non-cancellable period – e.g. if a lessee exercises a renewal option that it initially considered not to be reasonably certain to exercise. Following the guidance in IFRS 15 would require an entity to use the stand-alone selling prices at contract inception to allocate the change in the transaction price. An alternative view is to allocate the updated transaction price based on the stand-alone selling prices at the remeasurement date, including by accounting for the lessee's exercise of the renewal option as a lease modification (which is what US GAAP requires).

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.

Our overall impression is that the disclosure requirements for lessees' lease-related cash flows result in useful information for users of the financial statements. However, we acknowledge that the usefulness of information about lessees' lease-related cash flows is primarily an issue for users to respond to, and our comments should be taken in that light.

One area that we believe the IASB could provide additional guidance on is the presentation of prepaid lease payments. We consider that the requirements are currently unclear and could potentially lead to differences in practice in terms of how payments to the lessor are presented, particularly when lease payments include both an up-front payment and regular periodic payments over the lease term.

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.

We are aware that significant cost was incurred initially by entities with large, complex lease portfolios when implementing IT solutions to assist with lease accounting. However, we also understand that for certain entities this has enabled them to produce more extensive and valuable information on their leases which has benefitted not just users, but those entities themselves.

Whilst questions about lessees' ongoing costs of applying the measurement requirements of IFRS 16 are primarily a topic for preparers, our perception is that they are comparatively lower than the initial costs discussed above and generally as expected.

We are aware that the ongoing costs of applying the accounting standard are higher for entities who reassess or modify their lease contracts frequently; however, we understand that the resulting information is valued by users. We also note that if the IASB were to substantially change the requirements of IFRS 16 at this stage, then entities would incur significant new costs in changing their accounting systems, processes and internal controls. It would also potentially break converged measurement guidance with US GAAP. Therefore, we would caution against such change.

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.

We consider IFRS 16’s transition reliefs to have struck an appropriate balance between reducing costs to preparers whilst not overly compromising the usefulness of information to users and comparability between entities. We would encourage the IASB to follow a similar approach on future standard-setting projects.

We did observe that the placement of IFRS 1 transition requirements in the Basis for Conclusion paragraphs of IFRS 16 (i.e. BC299–BC302) created some confusion, because many jurisdictions do not publish these paragraphs due to their non-authoritative status. This may have led to diversity in practice. For future standard-setting projects, we suggest that the IASB include any IFRS 1 transition requirements in IFRS 1 itself, rather than the Basis for Conclusion paragraphs of the new accounting standard.

In concluding our comments on this question, we note that preparers are likely to be better placed to comment on the cost savings from the transition requirements and users and regulators better placed to comment on the reduced comparability between entities that resulted from them, both at the time of initial implementation and during the remaining term of the affected leases.

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.

We consider that the amendment to paragraph 2.1(b)(ii) of IFRS 9 made by the IASB as part of the *Annual Improvements to IFRS Accounting Standards* has not resolved the conflict between the requirements of IFRS 16 and IFRS 9 for modifications that do not involve changes to the lease contract other than the forgiveness of specifically identified lease payments.

As a result, it remains unclear whether the lessee should apply the derecognition requirements in IFRS 9 to the extinguished part of the lease liability and recognise the effect in the statement of profit or loss or apply the modification requirements in IFRS 16 and recognise the effect against the ROU asset.

For those modifications that only involve the forgiveness of specifically identified lease payments, based on the current accounting standard, we are aware of three potential approaches, as follows.

- *Full IFRS 16 approach*: under this approach, the lessee remeasures the lease liability using a revised discount rate, recognising the difference between the carrying amount of the modified lease liability and the lease liability immediately before the modification as an adjustment to the ROU asset.
- *Partial IFRS 9 approach*: under this approach, the lessee derecognises the lease liability for the lease payments forgiven with a corresponding adjustment to profit or loss in accordance with IFRS 9. The lessee then remeasures the lease liability for the remaining lease payments using a revised discount rate, recognising an offsetting adjustment to the ROU asset equal to the change in the carrying amount of the lease liability resulting from the remeasurement effect of the revised discount rate in accordance with IFRS 16.
- *Full IFRS 9 approach*: under this approach, the lessee derecognises the lease liability for the present value of the lease payments forgiven with a corresponding adjustment to profit or loss and does not remeasure the lease liability.

Accordingly, we observe diversity in practice on this issue. We therefore suggest that the IASB undertakes a narrow-scope project to clarify the distinction between lease modifications and financial liability extinguishments, and which standard should apply to modifications that only forgive specifically identified lease payments. In relation to this, our own recommendation would be to bring all modifications that meet the IFRS 16 definition of a lease modification entirely in the scope of IFRS 16.

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.

We have regularly observed difficulties in assessing whether such a transaction is a sale, predominantly due to the lack of clarity in IFRS 16 over the unit of account for assessing whether a sale has taken place (e.g. when a seller-lessee transfers a building and leases back only some floors). We therefore recommend that additional guidance be provided on how to make the assessment.

We also note that paragraph B46 of IFRS 16 states that “If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for applying paragraphs 98–103”.

The issue of how to assess whether the lessee controls an asset before lease commencement is frequently raised. We believe that it would be helpful if the IASB added guidance on this, including factors to consider in the assessment. In doing so, the IASB may wish to consider the factors listed in paragraph 842-40-55-5 of US GAAP, which would also serve to promote convergence.

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.

Whilst the question regarding the costs and usefulness of information relating to sale and leaseback transactions seems to be primarily targeted at preparers and users respectively, our own view is that restricting the amount of gain (or loss) that an entity recognises in a sale and leaseback transaction provides a conceptually correct answer, which provides useful information.

However, we note that there is currently a lack of clarity on the accounting for the sale of a subsidiary when one or more of the assets held by a subsidiary is leased back. This may result in diversity in practice and therefore less useful information. We understand that this issue of the interaction between IFRS 10 and IFRS 16 is currently in the IASB’s maintenance pipeline projects. We recommend that the IASB prioritises it.

Question 6.4 – Other matters relevant to the assessment of the effects of IFRS 16
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<p>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.</p>

<p>Please refer to ‘Guidance for responding to questions’ on pages 7–8.</p>
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In addition to the matters identified by the IASB in the Request for Information, there are several other matters relating to lease accounting that we believe the IASB should consider clarifying. We highlight the most important areas below. These include several areas relating to lessor accounting as well as the treatment of non-monetary consideration. In addition, we have highlighted some other issues in Appendix B to this letter. We see these as less important than the issues we have set out below.

Lessor accounting — Introduction

We appreciate that when the IASB was developing IFRS 16, its view was that lessor accounting should not be amended. However, we believe that IFRS 16’s greater guidance on lessee accounting has led to increased focus on lessor accounting too. This has highlighted a number of gaps in the current framework for lessor accounting, and there are certain improvements that could be made.

Lessor accounting – Unguaranteed residual values

Change to lease term

We believe that it would be helpful if more guidance was provided on how to deal with unguaranteed residual values, particularly when there is a change to the lease term as a result of either a modification or the lessee exercising an option. For example, when the lease term is extended, should the unguaranteed residual value be reassessed?

Conversely, when the lease term is reduced, should the unguaranteed residual value be increased? We have observed that this is a common issue and additional guidance would be beneficial.

Interaction with IFRS 9's impairment provisions

Whilst a lessor is required to apply the impairment provisions of IFRS 9 to the net investment in the lease, there is currently no guidance on how the requirements of IFRS 9's expected credit loss model should be applied to the unguaranteed residual value, which can lead to diversity in practice. Additional guidance on this issue would also be helpful.

Lessor accounting – Recognition of inappropriate 'Day 1' gains or losses

Separately, we also consider the accounting outcomes to be inappropriate for certain scenarios involving lessors with variable lease payments. For example, when a lessee has a head lease with fully variable payments, it does not recognise a ROU asset or lease liability under the current requirements. If it then has a sub-lease relating to the same underlying asset with fixed lease payments for the same lease term (indicating that the lease should be classified as a finance lease), then it recognises a net investment in the lease but there is no ROU asset relating to the head lease in the statement of financial position that can be derecognised. This results in a 'Day 1' gain equal to the full amount of the net investment in the sub-lease being recorded in the statement of profit or loss.

Similarly, when a lessor has a lease with fully variable payments that is classified as a finance lease despite the existence of the variable payments (i.e. because other factors indicate that classification as a finance lease is appropriate after considering the guidance in paragraph 65 of IFRS 16), the accounting standard requires that no net investment in the lease be recorded, despite the underlying asset being derecognised. This results in a loss being recorded in the statement of profit or loss on day 1 equal to the carrying amount of the underlying asset.

We consider both of these to be inappropriate accounting outcomes, because the volatility in the statement of profit or loss does not reflect the underlying economics of the transaction. We suggest the IASB adopt a similar approach to US GAAP, under which an amendment to Topic 842 (Accounting Standards Update 2021-05) was made to prevent this accounting occurring by classifying such leases as operating leases.

Non-monetary consideration

We also believe that more guidance on the measurement of non-monetary consideration would be useful to entities, given it is common in many lease agreements. For example, in some countries lease payments for land may be made in fixed quantities of specified agricultural produce to be delivered on fixed dates under the contract.

Our presumption is that non-monetary consideration should be measured at fair value, and this is consistent with what we have observed in practice, although this is not specified in the accounting standard. However, when the consideration is initially measured at fair value, there is a separate question in practice about whether that fair value should be derived by reference to the gross value of the estimated future payments based on today's spot values and then discounted back (consistent with the approach IFRS 16 requires for monetary consideration), or by using forward rates (i.e. no discounting), which would be more in keeping with an IFRS 13 *Fair Value Measurement* type approach.

We consider this matter to be relatively significant given that it is an issue for both lessee and lessor accounting and so further guidance from the IASB would be useful.

Appendix B – Other matters

Whilst we consider the following matters to be less significant than those discussed earlier in our response, we have observed them in practice, and therefore draw the IASB's attention to them to consider in its review.

Lease term

- How to determine the non-cancellable period of a lease that includes contingent termination provisions.
- How to determine the lease term when the written contract has ended but the lessee continues to use the underlying asset (i.e. a 'holdover period').
- When a lease contract includes substitution rights, should the lease term be calculated based on the period of use or the entire non-cancellable contract term.

Variable lease payments

- Should a lease liability with lease payments which are payable at the end of the year and increase each year based on the change in the CPI in the preceding year, be remeasured at the date when:
 - the future payments become known (i.e. end of Year 1); or
 - when making the new lease payment (i.e. end of Year 2).
- How a lessee should recognise payments that depend on undercutting or exceeding a contractually agreed level of usage, in cases in which these payments are made before the agreed level of usage is reached.
- Clarification of what is considered an index or a rate for inclusion in the measurement of the lease liability (e.g. in relation to commodities).

Sale and leaseback transactions

- For fungible items (e.g. commodities) subject to a sale and leaseback transaction, the conflict between applying the failed sale requirements (e.g. due to a repurchase option under IFRS 15) and the likelihood that the definition of a lease will not be met under IFRS 16, noting that practice may have developed since IFRS 15 (and the discussion in BC425 of the accounting standard) was published.

Lessor accounting

- Paragraph 21 of IFRS 16 lists circumstances in which the non-cancellable period of a lease may change, including decisions made by the lessee and an event occurring that contractually obliges or prohibits the lessee from exercising an option. The accounting standard does not address the impact on the lease term of the ability of the lessor to control the exercise of an option. We are aware of instances in practice where this is the case and suggest the IASB add guidance or examples to assist entities.

- Whether a lessor should reassess lease classification on exercise by the lessee of a renewal option that had been assessed at inception as not reasonably certain to be exercised.
- Whether a lessor should remeasure variable lease payments that depend on an index or a rate or that become in-substance fixed.
- Whether a lessor should continue to recognise lease income when a lessee is in financial difficulty. We believe that impairment may not be a solution because IFRS 9 applies only to lease receivables and not to accrued lease income.

Interaction with other standards

- Paragraph 80(b) of IFRS 16 requires the lessor to apply IFRS 9 when fixed lease payments are modified to variable lease payments. However, we note that under IFRS 9, the expected payments model would apply, which is inconsistent with IFRS 16's guidance on variable lease payments.
- For assets that take a while to construct (e.g. ships), there is a conflict between IFRS 15's requirement for income recognition over time and IFRS 16's requirement for a manufacturer or dealer lessor to recognise income at a point in time.

Appendix C – Illustrative example of lease payments that periodically become fixed for a short period of time

Example scenario

- Company B enters into a 20-year lease of retail space in a shopping mall.
- Lease payments are determined based on 30 percent of the lessee's actual sales for the previous 2 years.
- At the commencement date, the future lease payments are unknown, with the lease payments becoming fixed every 2 years for the following period.
 - In Years 1–2, lease payments would be determined based on actual sales in Years 1–2 respectively.
 - At the end of Year 2, lease payments for Years 3–4 become fixed based on actual sales in Year 2.
 - At the end of Year 4, lease payments for Years 5–6 become fixed based on actual sales in Year 4, and so on.
 - The lease payments become fixed periodically for every 2 years within 20 years.

It is questionable whether the words '...become fixed for the remainder of the lease term' in paragraph B42 (a)(ii) of IFRS 16 apply to such a scenario, i.e. it is not clear whether Company B should remeasure the lease liability for in-substance fixed payments or account for them as variable payments (it is questionable whether the variability of lease payments for the 20-year lease is resolved, when only 2 years of payments are fixed).

If Company B treats the payments as in-substance fixed payments and applies the remeasurement guidance, then the ROU asset would be adjusted for the remeasurement of the lease liability. The ROU asset would then be depreciated over the remaining lease term even though it only consists of lease payments for the following 2 years. This can lead to significant distortion in profit or loss as illustrated below.

Illustration
 Lease term: 20 years
 In Years 1-2, lease payments are fully variable and determined based on 30% of the lessee's actual sales.
 Variable lease payments become fixed every 2 years for the following 2-year-period.
 At the end of Year 2, lease payments for Year 3-4 become fixed based on actual sales in Year 2.

Year	Sales (Actual)	Lease payment			ROU asset					PL				
		Variable payment (a)	Variable payment become fixed (b)=(a)*30%	Variable payment become fixed (c)=(a)*30%	Beginning balance (d)	Addition (e)	Total (f)=(d)+(e)	Remaining lease term (g)	Depreciation (h)=(f)/(g)	Ending balance (i)=(f)-(h)	Sales	Other Expenses	Lease expense	Depreciation
1	1,000	300	0	0	0	0	20	0	0	1,000	-500	-300	0	200
2	1,000	300	0	0	0	0	19	0	0	1,000	-500	-300	0	200
3	1,000	0	300	0	600	600	18	33	567	1,000	-500	0	-33	467
4	1,000	0	300	567	567	567	17	33	533	1,000	-500	0	-33	467
5	1,000	0	300	533	600	1,133	16	71	1,063	1,000	-500	0	-71	429
6	1,000	0	300	1,063	600	1,063	15	71	992	1,000	-500	0	-71	429
7	1,000	0	300	992	600	1,592	14	114	1,478	1,000	-500	0	-114	386
8	1,000	0	300	1,478	600	1,478	13	114	1,364	1,000	-500	0	-114	386
9	1,000	0	300	1,364	600	1,964	12	164	1,801	1,000	-500	0	-164	336
10	1,000	0	300	1,801	600	1,801	11	164	1,637	1,000	-500	0	-164	336
11	1,000	0	300	1,637	600	2,237	10	224	2,013	1,000	-500	0	-224	276
12	1,000	0	300	2,013	600	2,013	9	224	1,790	1,000	-500	0	-224	276
13	1,000	0	300	1,790	600	2,390	8	299	2,091	1,000	-500	0	-299	201
14	1,000	0	300	2,091	600	2,091	7	299	1,792	1,000	-500	0	-299	201
15	1,000	0	300	1,792	600	2,392	6	399	1,993	1,000	-500	0	-399	101
16	1,000	0	300	1,993	600	1,993	5	399	1,595	1,000	-500	0	-399	101
17	1,000	0	300	1,595	600	2,195	4	549	1,646	1,000	-500	0	-549	49
18	1,000	0	300	1,646	600	1,646	3	549	1,097	1,000	-500	0	-549	49
19	1,000	0	300	1,097	600	1,697	2	849	849	1,000	-500	0	-849	-349
20	1,000	0	300	849	600	849	1	849	0	1,000	-500	0	-849	-349

Depreciation expense will be significantly increasing as it gets closer to the end of the lease term.
In this example, the lessee would ultimately incur a net loss due to variable lease payments based on its sales despite recognising consistent sales revenue for each period.