

**Sue Lloyd  
Chair  
IFRS Interpretations Committee  
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Canary Wharf  
London  
E14 4HD  
United Kingdom**

**Ref: The IFRS Interpretations Committee's June 2019 tentative agenda decisions**

Dear Mrs Lloyd,

The European Securities and Markets Authority (ESMA) would like to thank you for the opportunity to respond to the IFRS Interpretations Committee's (IFRS IC) publication of three tentative agenda decisions in the June 2019 IFRIC Update. One relates to the application of IFRS 15 *Revenue from Contracts with Customers* and two to IFRS 16 *Leases*. We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRSs.

Compensation for Delays and Cancellations – IFRS 15

ESMA has considered the IFRS IC's tentative decision not to add to its standard-setting agenda the request to clarify how an airline accounts for its obligation to compensate customers for delayed or cancelled flights through lump-sum payments. ESMA notes that the IFRS IC concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine its accounting for such obligation. ESMA agrees with the Committee's conclusion that the compensation for delays or cancellations described in the request is a variable consideration. Consequently, entities need to apply paragraphs 50–59 of IFRS 15 when accounting for its obligation related to such compensation.

However, ESMA regrets that the Committee did not consider the question of whether the amount of compensation recognised as a reduction of revenue is limited to reducing the transaction price to nil. ESMA notes that this was one aspect of its submission to the IFRS IC<sup>1</sup> and would have expected that the IFRS IC considered this question and documented its discussion in the agenda decision.

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<sup>1</sup> Letter, Agenda Item Request: Presentation of lump-sum compensation payments in the airline industry (IFRS 15), ESMA32-63-711, 17 April 2019, (cf paragraph 10 of the Appendix)

While ESMA understands that this aspect might relate to fundamental aspects of application of IFRS and thus IFRS IC might not be able to address the issue, ESMA would have expected that the IFRS IC considered the issue, e.g. by referring this matter to the Board in order to be addressed in the future post-implementation review of IFRS 15. Therefore, ESMA suggests that the final agenda decision mentions how the IFRS IC considered the issue.

#### Lessee's Incremental Borrowing Rate – IFRS 16

ESMA has considered the IFRS IC's tentative decision not to add to its standard-setting agenda the request to clarify the definition of a lessee's incremental borrowing rate in IFRS 16. ESMA notes that the IFRS IC concluded that the principles and requirements in IFRS 16 provide an adequate basis for a lessee to determine its incremental borrowing rate.

While ESMA acknowledges that the definition of a lessee's incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments, ESMA considers that the underlying economic principles on which the IFRS 16 model is based would require the presence of such similarity.

From its initial observation of the implementation activity, ESMA notes that most issuers reflect the payment profile of the cash flows in the determination of the incremental borrowing rate. This is because they consider that the proper reflection of the payment profile is necessary to faithfully represent the economic characteristics of the lease contract. Furthermore, they argue that this is in accordance with the Board's decision to take into account the terms and conditions of the lease to define the lessee's incremental borrowing rate (paragraph BC 162 to IFRS 16).

Additionally, ESMA notes that the objective of IFRS 16 is to ensure that lessees provide relevant information in a manner that faithfully represent lease transactions (paragraph 1 of IFRS 16). ESMA considers that from this perspective, the agenda decision might lead to a conceptual flaw in the application of the standard. Indeed, it appears inconsistent to require the use of the rate implicit in the lease which reflects the payment profile of the lease payments, while, if that rate cannot be readily determined, to allow the use of an incremental borrowing rate without the need to consider the payment profile of the lease payments.

Furthermore, ESMA notes that the US Financial Accounting Standards Board (FASB) reached the conclusion under the US GAAP that payment profile of the cash flows need to be considered when determining the incremental borrowing rate. As such, ESMA considers that it would be unfortunate that an unnecessary future divergence between IFRS and US GAAP would be introduced in this area.

Consequently, ESMA considers that the IFRS IC could have gone further in the agenda decision by explaining that readily observable rate for a loan with a similar payment profile to that of the lease need to be considered in the determination of the incremental borrowing rate rather than stating that '*a lessee might often refer [to such rate] as a starting point*'.

Should the IFRS IC believe that reaching such conclusion in the agenda decision is impossible without undertaking a standard-setting activity, ESMA considers that the IFRS IC should recommend to the Board to amend the standard in this respect and explicitly require consideration of the payment profile in the definition of a lessee's incremental borrowing rate. ESMA considers that such conclusion is necessary to prevent diversity in practice and ensure consistent application and enforceability of IFRS 16 requirements.

If the IFRS IC or the Board maintain the current position, ESMA encourages the Board to reach out to the FASB to understand why different conclusions have been reached on a part of the standard previously considered as converged.

### Lease term and useful life of leasehold improvements – IFRS 16

ESMA has considered the IFRS IC's tentative decision not to add to its standard-setting agenda the request to clarify how to determine the lease term of a cancellable lease or a renewable lease. Specifically, the request asked whether, when applying paragraph B34 of IFRS 16 and assessing 'no more than an insignificant penalty', an entity considers the broader economics of the contract, and not only contractual termination payments.

ESMA agrees with the conclusion reached by the IFRS IC that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine the lease term of cancellable and renewable leases. Especially, ESMA agrees that in determining the lease term and assessing the length of the non-cancellable period of a lease (including cancellable or tacitly renewable leases), paragraph B34 of IFRS 16 requires an entity to determine the period for which the contract is enforceable. ESMA welcomes the emphasis in the agenda decision that if only one party has the right to terminate the lease without the permission of the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that party.

ESMA equally welcomes the conclusion that in applying paragraph B34 and determining the enforceable period of the lease, an entity considers the broader economics of the contract, and not only contractual termination payments.

However, ESMA considers that the Committee could have further explained in the agenda decision what is meant by 'more than an insignificant penalty'. This would be consistent with the insight on the application of IFRS 16 requirements on lease term provided by the October 2017 IASB webcast.<sup>2</sup> Consequently, in order to improve consistent application and enforceability of IFRS 16, ESMA considers that the IFRS IC could include in the final agenda decision specific explanations and considerations that were included in the webcast.<sup>3</sup>

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<sup>2</sup> Webcast, Lease term Q&A by Darell Scott (Board member), October 2017, <https://www.ifrs.org/webcast/?webcastid=1163617>, See also Letter, Agenda Item Request: Determination of the lease term, ESMA32-63-697, 29 March 2019, [https://www.esma.europa.eu/sites/default/files/library/esma32-63-697\\_ifrs\\_ic\\_on\\_ifrs\\_16\\_lease\\_term\\_cancellable\\_lease.pdf](https://www.esma.europa.eu/sites/default/files/library/esma32-63-697_ifrs_ic_on_ifrs_16_lease_term_cancellable_lease.pdf).

<sup>3</sup> These might include examples of possible economic outflows related to termination that need to be assessed as well as other considerations to be taken into account where relevant (such as past practice in using the termination (or extension) options).



Finally, ESMA also welcomes and agrees with the conclusion made by the Committee on the useful life of the non-removable leasehold improvements stating that the useful life of the non-removable leasehold improvements is the same as the lease term if the entity does not expect to use the leasehold improvements beyond the lease term.

In case you have any questions or comments regarding this letter, please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

A handwritten signature in black ink, consisting of a stylized 'S' followed by a vertical line and a horizontal stroke.

Steven Maijor