IFRS 16 and IAS 34: Variable Lease Payments

Extract, IFRS Discussion Group Report on the Meeting – May 30, 2017

Paragraph 38(b) of IFRS 16 *Leases* and paragraph B7 of IAS 34 *Interim Financial Reporting* both refer to variable lease payments.

Paragraph 38 of IFRS 16 states:

> "After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:
>
> (a) interest on the lease liability; and
>
> (b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs."

However, paragraph B7 of IAS 34 states:

> "Variable lease payments based on sales can be an example of a legal or constructive obligation that is recognized as a liability. If a lease provides for variable payments based on the lessee achieving a certain level of annual sales, an obligation can arise in the interim periods of the financial year before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity, therefore, has no realistic alternative but to make the future lease payment."

Issue: When is the variable lease payment required to be expensed and included in the lease liability in the following two fact patterns?

Fact Pattern 1

An entity leases an asset for one year and has not elected the short-term lease exemption for that class of assets. Under the terms of the one-year lease, the lessee is required to make an additional payment of $100,000 at the end of the lease on December 31 if its sales for the year exceed $1 million. At inception, the lessee estimates that its sales will exceed the threshold during the year and therefore expects that the extra amount will be payable at December 31. The $1 million sales threshold is exceeded on September 15.

The two views under this fact pattern are as follows:

- View A – In the first quarter of the year as supported by IAS 34.
- View B – In the third quarter of the year as supported by IFRS 16.

Fact Pattern 2

Under the terms of a four-year lease, the lessee is required to make an additional payment of $100,000 on June 30 of the fourth year if its cumulative sales in the first three years exceed $3 million. At inception, the lessee estimates that its sales will exceed the threshold sometime during the first three years and therefore the extra amount will be payable.

In the first quarter of year 3, the lessee concludes that it is highly probable that the threshold will be met that year given the cumulative results in years 1 and 2, and the backlog of orders for year 3 production. The $3 million cumulative sales threshold is actually exceeded on September 15 in year 3.

The three views under this fact pattern are as follows:

- View A – In the first quarter of year 1 as supported by IAS 34. This view is based on the expectation at inception that the threshold will be achieved at some point during the first three years.
- View B – In the first quarter of year 3 as supported by IAS 34. This view is based on the expectation that the threshold will be met that year, whereas in earlier periods it was unclear when it would be met, and the higher level of probability.
- View C – In the third quarter of year 3 as supported by IFRS 16.

The Group's Discussion

The Group considered both fact patterns together. Group members agreed that there is tension between IFRS 16 and IAS 34 because of the explicit requirement in paragraph 38(b) of IFRS 16.

The Group noted that the application of IFRS 16 should not be affected by the requirements in IAS 34 as the latter is a standard for preparing interim financial statements. IFRS 16 is clear that variable lease payments are recognized in the annual period in which the triggering event or condition occurs. However, there is insufficient application guidance in IAS 34 (i.e., there is very little guidance that tells an entity how best to attribute the payments across the interim reporting periods).

The Group also considered whether the tension exists between IAS 34 and the current lease standard, IAS 17 *Leases*. The Group noted that IAS 17 does not have a similar requirement to what is explicitly stated in paragraph 38(b) of IFRS 16 and observed that preparers tend to follow the illustrative example accompanying IAS 34 (i.e., paragraph B7). However, one Group member noted that there seems to be an internal conflict within the requirements in IAS 34 and this illustrative example. In particular, paragraph 39 of IAS 34 states "costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year."

Group members observed that this issue highlights the shortcomings of IAS 34 as opposed to a problem with IFRS 16. Given the clear requirements in IFRS 16, the challenge is how to integrate those requirements with the interim reporting model.

As there is potential for diversity in practice, the Group recommended that the issue be discussed with the AcSB to determine whether it should be raised to the IASB or IFRS Interpretations Committee.

(For a full understanding of the discussions and views expressed, listen to the audio clip).