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Interpretation of the concept of liabilities in lease accounting

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ABSTRACT

The reform of lease accounting for lessees has brought about a major change that has required the interpretation of the concept of assets and liabilities. The lease project arose from a lack of information about the entity's liabilities, as some users believed that operating lease commitments should be reported as liabilities of the entity.
Concepts are fundamental in a principles-based standard. IFRS 16 was a controversial standard and subject to strong pressure, especially from preparers, and not only conceptual positions were involved in the deliberation process. As a principles-based standard should be interpreted following those principles, this paper examines the interpretative decisions following the adoption of IFRS 16 to analyze whether they are consistent with the concepts used in the standard, particularly the concept of liabilities.
Our results show that the standard and the basis for its conclusions have needed clarification or, in some cases, were interpreted inconsistently with the criteria under which IFRS 16 was issued. We argue that these departures have occurred because the Basis for Conclusions of IFRS 16 does not clearly reflect the concept of liabilities and they suggest that an explicit interpretation of the concepts is needed, either in the standard or in the doctrinal literature; otherwise, the standard may abandon its vocation of principles-based regulation. Our findings are relevant to standard setters, particularly for the IASB when addressing the post-implementation review of IFRS 16, and preparers and auditors who must apply the standard.

Interpretación del concepto de pasivo en la contabilidad de arrendamientos

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RESUMEN

La reforma de la contabilidad de los arrendamientos para los arrendatarios ha supuesto un cambio importante que ha requerido la interpretación del concepto de activo y pasivo. El proyecto de arrendamientos surgió de la falta de información sobre el pasivo de la entidad, ya que algunos usuarios consideraban que los compromisos por arrendamiento operativo debían reconocerse como pasivos de la entidad.
Los conceptos son fundamentales en una norma basada en principios. La NIIF 16 fue una norma controvertida y sometida a fuertes presiones, especialmente por parte de los preparadores, y en el proceso de deliberación no solo intervinieron posiciones conceptuales. Dado que una norma basada en principios debe interpretarse de acuerdo con dichos principios, este trabajo examina las decisiones interpretativas adoptadas tras la adopción de la NIIF 16 para analizar si son coherentes con los conceptos utilizados en la norma, en particular el concepto de pasivo.
Nuestros resultados muestran que la norma y el fundamento de sus conclusiones han necesitado aclaraciones o, en algunos casos, se han interpretado de forma incoherente con los criterios conforme a los cuales se emitió la NIIF 16. Argumentamos que estas desviaciones se han producido porque la base de conclusiones de la NIIF 16 no refleja claramente el concepto de pasivo y sugerimos que es necesaria una interpretación explícita de los conceptos, ya sea en la norma o en la literatura doctrinal; de lo contrario, la norma podría abandonar su vocación de regulación basada en principios. Nuestras conclusiones son relevantes para los responsables de la elaboración de normas, en particular para el IASB a la hora de abordar la revisión posterior a la aplicación de la NIIF 16, y para los preparadores y auditores que deben aplicar la norma.

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1. Introduction

International Financial Reporting Standard 16 - Leases (IFRS 16), issued by the International Accounting Standards Board (IASB), entered into force in 2019. This standard has been highly controversial, and its development process has dragged on for ten years, all without taking into account the earlier documents issued by the G4+1 Group in 1996 (McGregor, 1996) and 2000 (Nailor & Lennard, 2000), which were published ten years before the leases project was included in the joint agenda of the IASB and the Financial Accounting Standards Board (FASB) of the United States. The G4+1 consisted of the standard setters of Australia, New Zealand, the United Kingdom, Canada, the United States, and the International Accounting Standards Committee (IASC, the predecessor of the IASB).

The previous accounting for operating leases, in International Accounting Standard 17 - Leases (IAS 17), ignored the commitments acquired in the contract and the right to use the asset during the lease period in the balance sheet. This created an information deficit on the above concepts, which was more pronounced for the former (liabilities) than for the latter (assets). This is evidenced by the fact that rating agency analysts, when estimating companies' debt ratios, included lease commitments as corporate liabilities, using an estimate based on the annual lease expense (IFRS 16.BC3). This practice, therefore, revealed a lack of relevance of the financial information, which could be remedied by recognizing these liabilities on the balance sheet and thus better estimating future cash flows.

A second reason for the reform of the lease standard was the insufficient development of the treatment of variable payments and renewal options, which had been raised in the first paper published by the G4+1 in 1996 (McGregor, 1996). However, it was not until the second paper (Nailor & Lennard, 2000) that the issue was addressed in greater depth. The conceptual solutions to these problems highlighted the need to identify a general criterion that could provide a common response to similar situations. Kabir & Rahman (2018) argue that the due process documents that would lead to IFRS 16 were more principles-based in style than the final text, as the IASB took into account the demands of constituents and the cost constraint. Furthermore, these authors believe that the decision on accounting for term options, which followed a four-step process, resulted in a solution that was not consistent with the concept of liabilities in the conceptual framework in place at the time of IFRS 16's issuance.

The due process of IFRS 16 has revealed hesitant positions on the application of the concept of liability in lease contracts or clauses contained therein. The debtor's inability to cancel the contractual commitments is the criterion for determining whether the financing is a liability or equity, or whether the obligation is present or future. It is relevant to note that since 2013, the leases project has run concurrently with a discussion paper proposing the reform of the Conceptual Framework (IASB, 2013a; hereafter, CF). The conceptual progress since then mirrored the decisions on the leases project. However, as the CF was approved after the adoption of IFRS 16, the interpretation of the framework could not be included in the final version of IFRS 16, which would have been instrumental in resolving future questions arising on the interpretation of the standard.

The literature is not unanimous on the role of CFs. While it is argued that they help to develop new standards and interpret and fill gaps in concepts-based accounting standards, some authors have expressed concern and argued that CFs are formulated after experience in developing new standards and that they reinforce the legitimacy of existing standards (Dean & Clark, 2003; Walker, 2003; O'Brien, 2009; Zhang & Andrew, 2021). The obsolescence of a CF could invalidate its ability to guide the creation of new standards and lead to standards that are inconsistent with the concepts (Booth, 2003; Newberry, 2003; McGregor & Street, 2007). For example, Brouwer et al. (2015) show that the IASB has not always consistently applied the asset and liability concepts from the CF at the standard level. Regarding IFRS 16, chronologically, the tentative decisions on variable lease payments took place in 2011 (IASB, 2011), while the conceptual debate on the interpretation of the obligating event in the draft CF occurred two years later, in February 2013. Indeed, the existence of a present obligation in variable lease payments was one of the issues discussed (IASB, 2013b).

Conceptual underpinning is fundamental in a set of standards that is intended to be principles-based rather than rules-based. IFRS 16 has been controversial and has been subject to strong pressure, particularly from preparers. The application of IFRS 16, as discussed in this paper, raises the question of whether, given the usual doubts that arise when a standard is first applied, the decisions have been sufficiently underpinned by principles or whether these have been reflected in the subsequent interpretation.

Our study aims to analyze whether the interpretations and amendments to IFRS 16 after its first application have enriched the concepts of the standard and whether they are consistent with the interpretation of these concepts used in the process of adopting IFRS 16, particularly regarding the interpretation of the concept of liabilities.

The methodology used in our analysis is framed within the field of legal studies. Kestemont (2018) proposes several approaches to legal research. One of these is the recommendatory research objective. This strategy offers recommendations on how the law should be. The researcher describes the subject matter, evaluates it, and explains the current problems. The evaluation needs a normative criterion, which the researcher has to formulate explicitly because it contributes to the replicability of the recommendatory research objective. In addition, researchers need to justify this normative criterion to avoid their own bias. Normative frameworks are narrower than theoretical frameworks because the latter allows multiple research questions to be addressed, whereas, in legal studies, normative frameworks provide criteria for evaluation (Taekema, 2018). For Westerman (2011), the existing legal system is the theoretical framework. Following the classification proposed for research in these disciplines, the Pearce Report[1] identified doctrinal research as "*research which fosters a more complete understanding of the conceptual bases of legal principles and of the combined effects of a range of rules and procedures that touch on a particular area of activity*" (Duncan & Hutchinson, 2012: 101). Doctrinal research is therefore considered an appropriate methodology for this study, as it questions the concepts, principles and norms, collectively referred to as doctrine, that have been developed in practice (Duncan & Hutchinson, 2012). Our first task was to analyze the rationale behind the various documents published prior to the adoption of IFRS 16. This preliminary work allows us to interpret, with this reference, the questions submitted to the IFRS Interpretation Committee (IFRIC) and the Board after the adoption of IFRS 16. From a grounded-theory perspective, the analysis of these cases reveals that the principles formulated in IFRS 16 and its Basis for Conclusions

[1]Report issued in 1987 and prepared by a committee created in Australia that reviewed the research produced in law schools.

are imprecise for interpreting new situations.

Our findings show that the standard and the basis for its conclusions needed clarification or, in some cases, the solutions adopted by the IFRIC or the Board following the application of IFRS 16 were not consistent with the reasons that led to the passages in the standard. The conclusion that can be drawn is that there are tensions in the implementation of IFRS 16. We argue that the concept of liability is not clearly reflected in the Basis for Conclusions of this standard. For this reason, this paper demonstrates the need for a more explicit interpretation of the concepts, either in the standards or in the doctrinal literature, because otherwise, the standards may abandon their principle-based regulatory vocation.

The rest of this paper is structured as follows. Section 2 provides an overview of the liability concept in the conceptual framework, specifically in relation to lessee accounting. In Section 3, we examine the issues that have emerged subsequent to the implementation of IFRS 16 concerning the concept of liabilities, with a particular focus on the concept of obligation and the obligating event. Section 4 delves into the liability arising from past events and explores how parties manage uncertainties within contracts. Finally, in Section 5, we draw conclusions and highlight implications that may be of relevance to the IASB in their post-implementation review of IFRS 16.

2. The concept of liabilities

The concept of liabilities has evolved with the changes introduced in the CF in 2018. The CF now defines a liability as a present obligation to transfer an economic resource as a result of past events. This definition has removed the reference to the expected outflow of "*resources embodying economic benefits*" contained in the previous CF 2010 definition, thus moving uncertainty from the definition to the measurement of the liability. The interpretation of the concept of liability has been a subject of contention, both within standard setting and academic literature, highlighting the challenges involved. In this section, we draw attention to two contentious issues pertaining to lease accounting: the executory contract doctrine and conditional obligations.

The first issue is executory contracts. These are contracts where neither party has fulfilled its contractual obligations. On the other hand, there are fully or partially performed contracts where one or both parties have fulfilled all or part of their obligations (Rouse, 1994). Accounting standards recognize fully or partially performed contracts, but the usefulness of including obligations and rights arising from executory contracts has been debated. Some authors argue that their recognition would improve the relevance of the information (Ijiri, 1980; Gujarathi & Biggs, 1988) because it would allow assets and liabilities to be recognized before the transaction is completed. For example, according to IAS 39 - Financial Instruments: Recognition and Measurement, financial assets and liabilities in financial contracts pending execution should be recognized at fair value (Walton, 2006). In contrast, other authors and pronouncements do not support this approach because they consider that the rights pending control would not be assets (Rouse, 1994; Nailor & Lennard, 2000).

In 2018, the CF defined an executory contract as "*a contract that is equally unperformed: neither party has fulfilled any of its obligations, or both parties have fulfilled their obligations partially and to an equal extent*" (CF 4.56). The CF considers that the resulting right and obligation are interdependent and inseparable and, therefore, would only be recognized if one had a value distinct from the other (CF 4.57). When one of the parties fulfills its commitments, the contract is no longer executory.

The second major issue is the effect of conditionality in the obligating event. Under current standards, the concept of a present obligation may be legally or contractually based and need not be unconditional. The key is that the entity does not have the practical ability to avoid the transfer of economic resources (cancellability). However, the CF foresees other situations in which an entity may have a limited ability to avoid the transfer of assets, and this does not mean that there is no present obligation (e.g., there would be no practical ability to avoid constructive obligations arising from expectations created among customers). The conditional nature of the obligations raises the issue of whether those obligations are present or will arise when the future event that makes the sacrifice of economic resources unavoidable occurs.

Regarding the concept of a present obligation, the issue of cancellability was discussed during the reform of the CF. The following three alternatives to the notion of "*avoidance of future payments*", which had been observed in the accounting regulation, were evaluated:

- The first approach considers that the entity should not have any theoretical possibility to avoid payment. This is a very restrictive view, according to which all situations in which the entity has some possibility of avoiding payment would cease to be liabilities.

- A second and less strict view is that the entity should not have the practical ability to avoid payment. In these cases, the entity could theoretically avoid payment, but it is economically undesirable to do so, or there is an economic incentive or economic compulsion.

- The third approach considers that a liability exists when it is probable that the entity will have to transfer a resource, irrespective of the entity's theoretical or practical ability to avoid payment.

As noted in the Basis for Conclusions of the CF (BC.4.51), accounting standards have conflicting views on the scope of the term "cancellability" and the role of economic incentives. From a very narrow view of the concept of liabilities in classifying an instrument as liability or equity, IAS 32 - Financial Instruments: Presentation and IFRIC 21 - Levies disregard economic incentives that may show that there is no practical ability to avoid payment (Brouwer et al., 2015). This position is maintained in the Discussion Paper Financial Instruments with Characteristics of Equity (June 2018 DP. 8.2), following the approval of the CF (March 2018).

However, economic incentives need to be considered when deciding whether the obligation is present or future. Therefore, the CF opted for the second point of view because if the entity has the right to avoid payment but does not have the practical ability to do so, that right is spurious, and not recognizing the obligation as a liability would give legal form precedence over economic substance, thereby circumventing the characteristic of faithful representation.

The question of whether the obligation arises from a past event is also raised in relation to conditional obligations. Murray (2010) discusses the case of warranties given to third parties. In such cases, it is important to identify the event that triggers the obligation to repair, i.e., the damage that triggers the warranty or, conversely, the obligation to be ready to repair it if the damage occurs, when the price for that service has already been received from the customer (either as a performance obligation independent of the delivery or in combination with the delivery itself). If it does not depend on the debtor, the conditionality becomes unavoidable and should be included in the measurement of the liability.

3. The concept of obligation in the application of IFRS 16 to lease liabilities

The development of the liability concept in the lease project has sparked debates akin to those observed during the discussions on the conceptual framework. The process commenced with the publication of two G4+1 papers (McGregor, 1996; Nailor & Lennard, 2000), followed by the release of DP 2009 and Exposure Draft 2010/9 on leases. Further progress was made with the issuance of Exposure Draft 2013/6 on leases (ED 2013c), culminating in the final standard, IFRS 16. Notably, DP 2009 holds significant importance as it presented the IASB's preliminary views, incorporating broad conceptual approaches.

The Basis for Conclusions of IFRS 16 addresses the definition of liabilities in lease contracts as per the conceptual framework (IFRS 16.BC.25.a). In terms of the concept of a present obligation, the non-cancellable nature of the contract fulfills the requirement of non-avoidance of payments, as stated in the definition of a liability. For contracts that are fulfilled over time, the lease standard establishes a connection between the term of the obligation and its primary characteristic: non-cancellability. The previous and current lease standards (IAS 17 and IFRS 16) define the non-cancellable nature of these agreements to determine the term (IAS 17.4, 31.d, 35, 56 and IFRS 16.18, 21. Appendix A, B34 and B35) as well as the payments to be considered (IFRS 16.IN12).

To date, the IASB and the IFRIC have addressed several issues related to the concept of obligation in the application of IFRS 16: (a) the important role of the legal framework in interpreting contractual lease obligations; (b) the financial or non-financial nature of lease obligations; (c) and the relationship between accounting standards and tax rules in determining when the lease obligation meets the definition of a liability.

3.1. Contracts define the obligation, the legal framework and the court's interpretation

The documents issued by the IASB during the IFRS 16 due process were silent on the influence of the jurisdictional framework on the assessment of the cancellability of the obligation, although some of the participants had argued the controversial application of non-cancellability under different jurisdictions in response to DP 2009 (Molina & Mora, 2015 cite US Chamber of Commerce). For instance, under Roman law, contracts bind the parties based on the general postulate of "*pacta sunt servanda*"; however, in the event of a change in circumstances of an extraordinary nature that alters the basis of the contract, the courts may apply the "*rebus sic stantibus*" clause based on a judgment of equity. In other words, in the event of an extraordinary change of circumstances, the agreements lapse. However, under English law, the flexibility of judges to adjust the terms of a contract is limited, as van Houtte (1993) notes: "*Under certain legal systems, such as public international law or English law, a judge or an arbitrator does not have the power to adapt contract terms to changed circumstances or to substitute new terms more suitable for the changed situation. However, under some legal systems, such as the German, the Dutch or the Japanese, the judges or arbitrators are empowered to adjust contracts to consider the changed circumstances.*"

The COVID pandemic and the forced business closures have led to a general review of many contracts, including leases. In this context, the first question that arose was how to account for changes in lease terms or reductions in lease payments due to COVID, in some cases as a result of negotiations between the parties, in others as a result of the application of change of circumstances clauses that had been brought before the courts. The IASB responded to these concerns in two amendments to IFRS 16 (IASB, 2020a; IASB, 2021a). These circumstances showed that the cancellability of the contract should be assessed not only in the light of the contract but also in the light of the legal framework in which the entity operates. However, the remote possibility that the legal authorities might require a revision of the terms and conditions should not prevent the contract from being considered non-cancellable. Agreements should be considered to be cancellable only when the likelihood is no longer remote, and the right-of-use model should not be applied.

The enforceability of the lessee's contractual obligations must be interpreted in light of the specific legal framework. Contracts are subject to the law in force, which limits or conditions the ability of the parties to commit themselves, but it is also necessary to consider how the courts of a given jurisdiction assess the ability to terminate a lease contract. The lease is signed in a situation of equilibrium between the parties, which, if altered, could be invoked to invalidate the agreement.

The non-cancellability of leases is critical to accounting under the right-of-use model. As this aspect of the definition was not clearly articulated in the standard or its Basis for Conclusions, the IASB had to develop it further in a subsequent interpretation. The IASB could have clarified in the Basis for Conclusions that this aspect of the definition of liability should be analyzed in the broader jurisdictional legal context and not just in the isolated contract.

3.2. The nature of the lease obligation

One issue that was not anticipated when IFRS 16 was initially issued relates to the coordination with the derecognition criteria for lease liabilities under IFRS 9. In the IASB's educational material (IASB, 2020b), a dual regulation for the extinguishment of lease liabilities has been identified. On the one hand, IFRS 9.3.3.1 assesses whether the lessee is relieved of its debt, with paragraph 3.3.3 indicating that such a reduction in the liability is recognized in profit or loss. On the other hand, the reduction of the liability may qualify as a lease modification, as set out in the definitions of IFRS 16: "*A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term)*". If the modification only impacts the amount and does not meet the criteria to be considered a separate lease, the liability should be measured using the discount rate at the modification date. In this case, there would be a corresponding reduction in the right of use (as outlined in IFRS 16.45-46). This issue, which could potentially create an accounting alternative in practice, has been raised by the European Securities and Markets Authority (ESMA).

As there is more than one way for a lessee to read the IFRS principles and requirements in accounting for the lease concession, the IFRIC has proposed that the Board undertake a narrow-scope amendment project (IFRIC, 2022a). IFRS 16 sets out its own criteria for derecognition through contract modification and the IFRS 9 derecognition criteria for lease liabilities remain in place, so the overlap between IFRS 9 and IFRS 16 needs to be clarified. For lessors, the IFRIC has approved a decision agenda whereby the lessor accounts for the derecognition of the operating lease receivable forgiven under IFRS 9 and the modification of future lease payments (not yet recognized as an operating lease receivable) under IFRS 16 as a new lease (IFRIC, 2022b). This doctrine does not apply to lessees, as lease liabilities are recognized from the inception of the lease contract. For lessees, the IFRS Interpretations Committee (IFRIC) has recommended that the IASB make amendments to the definition of "lease modification" by including the following statement: "*For a lessee, a change that results solely in a lease liability (or a part of it) being extinguished in accordance with IFRS 9 is not a lease modification*" (IFRIC, 2023). The minor correction stems from IFRS 9.2.1.b.ii), which indicates that "*lease liabilities recognized by a lessee are subject to the recognition requirements in paragraph 3.3.1 of this Standard*." IFRS 9.3.3.1 states, "*An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished - or when the obligation specified in the contract is discharged or cancelled or expires*." The difference between the derecognition of a financial liability and the consideration paid is recognized in the profit and loss statement in accordance with IFRS 9.3.3.3. However, IFRS 9.2.1.b.ii) does not explicitly refer to IFRS 9.3.3.3. After analyzing the case, the IASB will propose a narrow scope amendment in the annual cycle amendment, suggesting the inclusion of a cross-reference to IFRS 9.3.3.3 in IFRS 9.2.1.b.ii).

From our perspective, the conceptual issue lies in determining the financial or non-financial nature of lease liabilities. We believe that reductions in lease liabilities resulting from a decrease in the ability of the right-of-use to generate future cash flows should be excluded from the scope of IFRS 9. This is because lease financing involves a non-cash component (the right of use) as consideration upon its inception. In contrast, other financial liabilities governed by IFRS 9 involve cash as consideration, and therefore their reductions are only recognized in the profit and loss statement. A similar situation arises when a trade supplier reduces trade payables, and the entity recognizes a reduction in inventories or the cost of sales as they are consumed (as stated in IAS 2.11). The specific treatment of derecognition in IFRS 16 does not exclude the lease obligation from being considered a financial liability, as mentioned in IFRS 16.BC222. However, we believe that applying IFRS 9 or IFRS 16 to resolve this issue is difficult because the asset and liability originate from a contract that simultaneously regulates both elements. Our view is that IFRS 9 should serve as a residual standard for the accounting of lease assets and liabilities, similar to how it applies to trade receivables. In particular, IFRS 9.2.1.j) points out that "*rights and obligations within the scope of IFRS 15 Revenue from Contracts with Customers that are financial instruments, except for those that IFRS 15 specifies are accounted for in accordance with this Standard*". We suggest replacing the wording of IFRS 9.2.1.b) with a similar wording to paragraph j) "*rights and obligations within the scope of IFRS 16 Leases that are financial instruments, except for issues that IFRS 16 specifies are accounted for in accordance with this Standard*", for example, embedded derivatives in lease contracts (IFRS 16.BC81).

Lease liabilities finance the acquisition of non-operating assets and the treatment of any change in them needs to be analogous to other non-operating purchases. The previous treatment of the derecognition of lease receivables and lease payables in IFRS 9 was necessary because the derecognition of these rights and obligations was not addressed in IAS 17.

Our interpretation emphasizes the unique characteristics of lease obligations compared to other financial liabilities, aligning with the preliminary decisions of the Primary Financial Statements project. This project utilizes the ability to raise funds from liabilities as a criterion for classifying financial expenses in separate line items. Financing transactions typically involve two conditions: a) the entity receives cash, its own equity instruments, or a reduction of a financial liability, and b) the entity repays cash or its own equity instruments. Based on this approach, finance expenses arising from lease liabilities and trade payables are placed together on the same line (IASB, 2021b). The IASB's ongoing narrow scope amendment project or the post-implementation review of IFRS 16 may offer further clarification on the overlap between IFRS 9 and IFRS 16 in terms of derecognition criteria.

3.3 VAT as part of the lease obligation

Another issue related to the concept of a present obligation is the effect of non-refundable VAT on the determination of lease payments. The conceptual debate is whether the event that triggers the obligation has already occurred: the contract that obligates the lease payment or the event that must occur in the future because it is required by tax law.

As IFRS 16 is silent on this issue, it has been the subject of consultation for inclusion on the IASB agenda (IFRIC, 2021). However, it has not resulted in a standard-setting action due to its immaterial impact on the financial statements and the limited diversity in how lessees recognize these transactions. Conceptually, the first question to be addressed is whether VAT payments are part of the lease payments or just a cost of the right-of-use. If they are part of the lease payments, the non-refundable VAT increases the value of the lease liability and the right of use. If it is not part of the lease payments, the non-refundable VAT liability arises when it accrues for tax purposes, so that it would be treated as an expense for the period when the leased asset is placed in service. This interpretation is consistent with IFRIC 21 - Levies, which, when applied to this case, would mean that the tax on the use of the leased asset would arise when it is used rather than when it is transferred.

If non-refundable VAT is treated as a lease liability, the issue becomes more complex if the pro-rata rule that determines the extent of VAT deductibility is likely to change significantly. In our opinion, in these situations, it would be a variable payment for the lessee, and any future revision of the value of the liability should have as its counterpart the value of the right of use.

The issue can be summarized as follows: Should tax law or accrual accounting prevail? If the interpretation favors the inclusion of these tax obligations in lease payments, it should lead to a reconsideration of IFRIC 21.

The IASB could have clarified whether VAT should be considered as part of the lease obligation or whether it is a separate levy. This would help to define the relationship between the accounting standard and domestic tax rules.

4. Lease liabilities existing as a result of past events

The definition of a liability requires that the obligation arises from past events. One of the first questions to be resolved in a contract is whether one of the parties has fulfilled its contractual obligations. Another question is whether the supplier acquires one or more obligations. The latter refers to clauses included in the contract to manage uncertainty about the future performance of the leased asset. These are clauses that would change the term of the lease or those that would change the agreed price.

4.1. Executory contract doctrine when the lessor is required to make several deliveries over time

The previous lease standard, IAS 17, distinguished between operating and finance leases. Where the lessee did not obtain substantially all the risks and rewards of ownership of the leased asset (operating leases), the standard proposed that the leases should qualify as executory contracts because the lessor's obligation was fulfilled over time. For finance leases, the substance of the contract was equivalent to a credit purchase, and the delivery of the leased asset was the event that determined the transfer of risks and rewards. Under IFRS 16, the transferred asset has changed from being the physical element to the bundle of services associated with the leased asset. IAS 17 focused on the transfer of the physical asset, but IFRS 16 focuses on the right of use over the bundle of services of the underlying asset. In IFRS 16, the lease obligations are recognized as liabilities based on the lessor's fulfillment of the delivery of the underlying asset.

4.1.1. Are leases executory contracts? The debate before IFRS 16

Regarding the concept of a present obligation arising from a past event, one of the most persistent arguments against the right-of-use model in IFRS 16 was that operating leases were executory contracts. This criticism was expressed in the first G4+1 project (McGregor, 1996) and led the second project to devote a chapter to justifying that contracts classified as operating leases were not executory contracts (Nailor & Lennard, 2000). The DP 2009 analyzed the consistency of the right-of-use model with the CF 2010 definitions of assets and liabilities. Specifically, the DP 2009 stated that the resource and obligation arise as a result of a past event: the signing of the contract and delivery of the leased asset, and added that:

> *Some think that the lessee's right to use the machine described in example 1 is conditional on the lessee making payments during the lease term. In other words, if the lessee does not make payments, it may forfeit its right to use the machine (this is similar to the situation that would arise if an entity failed to make payments on an instalment purchase). However, unless the lessee breaches the contract, the lessee has an unconditional right to use the leased item.* (DP 2009: 3.16; this passage was incorporated into IFRS 16: BC.22.d).

However, the Basis for Conclusions to IFRS 16 clearly states that the lessee has a present obligation because the lessor has fulfilled its obligation to deliver the leased asset:

> "*the lessee has a present obligation to make lease payments once the underlying asset has been made available to the lessee. That obligation arises from past events—not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee. Unless the lessee renegotiates the lease, the lessee has no right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term.*" (IFRS 16.BC25 a)

Executory contracts have long been a controversial issue. Ma & Miller (1978) argue that leases that can be canceled or terminated within a short period are executory contracts that are not recognized as liabilities; however, if the lessee cannot avoid payments, the contract would be recognized as a liability. Management's discretion to avoid future payments causes the obligation to arise in the future when the service is received, whereas if the obligation leaves no room for management discretion, the liability arises when the obligation is incurred.

The lessee accounting model proposed in the DP 2009 was criticized in three ways, as documented by Molina & Mora (2015). The first is that the model does not reflect the business model underlying the contract; the second is the inconsistency of the model with the CF, as assets and liabilities are recognized as a consequence of a contract that is yet to be performed; finally, the third focuses on the complexity of the accounting and the possibility it opens up for manipulation. The second argument was highlighted in the ED 2010 Leases, not so much questioning the existence of rights and obligations but pointing out that this reform would imply a change in the accounting of executory contracts. Molina & Mora (2015) note that in the responses to the DP 2009, some respondents referred to analogous service contracts in an attempt to challenge the consistency between the treatment of these services and that proposed in the right-of-use model. The ED 2010 response clarified the issue by stating that the lessor executes the contract at the inception date of the lease, and this was included in the Basis for Conclusions of IFRS 16, which established that an obligation arises for the lessee from the moment it has the underlying asset at its disposal (IFRS 16: BC22.d and BC25.a).

4.1.2. The doctrine of executory contracts to resolve renewals of the leased asset

Leases may sometimes involve the lessor making several deliveries of the leased asset during the lease term. Molina-Sánchez (2021) presents the case of leases for a period longer than one year, but only for certain months. The main issue is the following: if control over the underlying asset is returned to the lessor at the end of each period of less than one year, the contract signed is a framework contract that is fulfilled when the lessor makes the underlying asset available to the lessee. On the other hand, the definition of the period of use in IFRS 16 may lead to the view that the term of the contract is the sum of non-consecutive periods ("*The total period of time an asset is used to fulfill a contract with a customer (including non-consecutive periods of time)*"). In our view, an interpretation based on the definition of the period of use would not be consistent with the nature of a contract that the lessor has already fully performed, as the lessor fulfills its obligations by making the underlying asset available to the lessee in successive deliveries.

One of the cases where this issue arises is when the lessor has a right of substitution or a substitution obligation (IFRS 16.B15). IFRS 16 addresses these cases in assessing whether the asset is identified but does not explicitly discuss whether the substitutions would qualify as new deliveries under the contract: some likely and some agreed.

Recently, the IFRIC received an inquiry in which the entity indicated that in a 10-year contract, it was expected that the lessor would have to replace the elements (batteries used in electric buses) in year three because substitution could be economically advantageous (IFRIC, 2023). In addition, the case indicated that it was very likely that the lessor would have to substitute the batteries after a period of time shorter than the lease term because their performance was lower than the lessee required. It was discussed whether the asset was identified in this contract as there was a substitution right that could be considered substantive through the period of use. To be substantive, the lessor must be able to substitute the leased asset throughout the period of use and benefit economically from such substitution (IFRS 16.B14). The decision taken is that there is no substantive right of substitution because, in the early years of the lease, the lessor has no economic incentive to substitute, and therefore the asset is identified.

The response from IFRIC aligns with the wording of IFRS 16. However, in our opinion, this particular case suggests that the analysis of asset identification should be linked to the determination of the lease term. This approach would allow certain contracts to be classified as leases for a specific period while the leased asset is identified, and then as service contracts thereafter, during which the lessor can replace and manage the leased asset based on their own interests. According to IFRS 16, the unit of account for a lease is not the contract itself. Instead, the standard defines a lease as "*A contract, **or part of a contract**, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration*" [emphasis added]. Therefore, it is possible for a contract to include both a lease and a service arrangement simultaneously. In our view, this rationalization of the submission to IFRIC (2023) is based on adhering to a rule rather than solely considering the economic substance of the agreement.

This consultation also raises a related issue regarding the treatment of probable substitutions that the lessor may need to make due to the poor performance of the leased asset. The timing of these future replacements impacts the estimation of the asset's useful life and the determination of the lease term. In this scenario, the executory contract doctrine would identify multiple obligations for the lessor, with the obligation to the lessee commencing as the lessor performs each delivery. Therefore, an additional delivery obligation should be treated as a new lease.

4.2. Clauses for managing uncertainty in complex leases: term clauses and variable payments

Uncertainty in any contract that will have future effects necessitates the implementation of mechanisms to manage it. Both lessors and lessees may possess similar or asymmetric knowledge regarding the future performance of the leased asset. Either way, they must address the uncertainty by including term or variable payment clauses. Term and variable payments based on usage are determined by the level of consumption of the leased asset, while index and performance-linked payments are determined by the price of the asset's services. This section delves into the interpretative challenges that the IFRIC and the IASB have faced since the release of IFRS 16 regarding considerations related to term and variable payments.

4.2.1. Analysis of clauses in the context of the contract prior to IFRS 16 adoption

An important discussion in the DP 2009 revolved around the criterion of past events and its application to *complex* leases. These leases encompass clauses designed to manage uncertainty for both the lessee and the lessor. Such clauses may involve options for the term or purchase, guaranteed residual values, or variable payments. While these provisions offer flexibility in terms and payments, the challenge lies in defining the unit of account for measuring the liability. The debate has centered around whether to consider the contract as a whole or analyze each set of clauses separately. On one side, proponents advocate treating the basic contract as a single entity while considering the term or other variable payment clauses as separate components. The possibility of employing component accounting for different clauses was discussed, as proposed in the second G4+1 report (Nailor & Lennard, 2000). This proposal suggested that each clause should be measured at its fair value if reliable measurement was feasible; otherwise, it should not be recognized. However, the DP 2009 proposal rejected this option due to the complexity involved in measuring the components. On the other hand, an integral approach would alleviate uncertainties regarding the nature of payment obligations in periods when the lessee lacks the ability to avoid payment. Under this approach, the lessee has a single payment obligation and determines the amount during the measurement decision. The implications for term options are addressed in this paragraph:

> *"However, under the single asset and liability approach tentatively adopted by the boards, the lease contract is viewed as giving rise to a single liability (the obligation to pay rentals) that may include rentals payable in optional periods"* (DP 2009: 6.8).

DP 2009 also examined whether the treatment of uncertainty in term clauses should be categorized as a recognition or measurement decision. In terms of recognition, one of the prerequisites is that it must meet the definition of an element. If the uncertainty in these clauses is taken into account when determining whether to recognize them, a component analysis is employed. However, surprisingly, the DP 2009 proposed an integrated approach to analyzing these term clauses. On the other hand, if the issue is approached from a measurement perspective, the contract term would encompass a probabilistic element that aligns with the integrated analysis.

Following the DP 2009, subsequent proposals such as ED 2010, ED 2013, and IFRS 16 introduced separate analyses for each contract term, adopting a component approach. However, certain aspects of IFRS 16 still maintain an integral view in order to assess the economic substance of the transaction. For instance, if a contract has a fixed term but includes provisions for early termination that can be exercised independently by both parties, it should be treated as a cancellable contract (IFRS 16. B34). In order to ensure a faithful presentation, the set of clauses collectively determines the presence of a present obligation, and each clause is not assessed in isolation.

The individual analysis of the clauses can also be seen in the debate on contingent payments, which has led to different positions in the documents issued by the IASB during the due process of IFRS 16. In the initial two documents, namely the DP 2009 and ED 2010, the IASB proposed that variable payments tied to usage and performance should be considered when measuring the lease liability, thus adopting an integral approach. However, in ED 2013 and IFRS 16, this type of variable payment is excluded based on either a high degree of subjectivity (a measurement issue) or because the payments may be avoidable, thereby not meeting the definition of a liability (a recognition decision) (IFRS 16.BC169).

In summary, the question of whether the obligation is the contract as a whole or whether each clause can become a separate obligation (i.e., the unit of account) has been an important and much debated issue. Positions have fluctuated and there has been a shift from an integral view of the contract to a separate analysis of each of these clauses. Central to the analysis is that a liability exists if the lessee does not have the practical ability to avoid it (uncertainty of existence). The concept of practical ability involves an analysis of economic substance and, thus, an improvement in information by enhancing the fundamental characteristic of faithful representation. This is how it should be interpreted and not as mere rules. Coetsee (2021) concludes that uncertainty about the existence of liabilities when they are not under the control of the entity is complex and requires a solution at the standard level.

4.2.2. Economic substance in the accounting treatment of term clauses

The term of leases has also been one of the most debated issues in the development of IFRS 16. If clauses allow either party to terminate a lease at any time, the lease is considered cancellable unless there is a penalty, and the penalty is not insignificant. In this context, the question is whether the concept of an insignificant penalty should be understood as a payment specified in a clause of the contract or whether it can be interpreted in a broader sense, considering as a penalty the existence of an economic incentive not to terminate the contract, for example, due to leasehold improvements to the leased asset. To analyze this issue, it is important to examine the decision-making process for termination clauses, as it reflects the rationale of IFRS 16. An interpretation of economic compulsion in determining the term that seeks a faithful representation is then presented. In addition, the IFRIC has clarified the combined effect of termination clauses for lessors and lessees on the substance of the lease (IFRIC, 2019).

a) The debate on the lease term prior to the adoption of IFRS 16

The provisions of IAS 17 on the lease term required an assessment of the economic substance of these clauses, both to determine whether purchase options had been exercised and to estimate the possible extension of the lease term. In both cases, the threshold was very high, so the objective was to indicate how the substance-over-form test was performed rather than to impose a stricter recognition criterion. This solution differs from a fair value model of liability measurement, which would include the expected value of the cash flows to be settled (Ryan et al., 2001).

The G4+1 proposals, on the other hand, applied a narrower concept of liability, so that term options should not be recognized because the lessee could avoid them and, therefore, would not have an obligation (Nailor & Lennard, 2000).

The DP 2009 proposed that the liability is formed by the set of clauses contained in the contract (i.e., the integral approach to determining the unit of account for lease liabilities). Therefore, the uncertainty about the exercise of the term option could be addressed in two ways. One is a recognition decision by estimating the lease term from the possible terms and the other is by measuring the liability using the expected value technique.

When the decision is about recognition, the lessee needs to analyze the contract clauses and assess the likelihood of its occurrence. The DP 2009 proposes that it should be the most probable period, thus considering the broadest view of the concept of liability, according to which a liability exists to the extent that the sacrifice of resources is probable, even if the entity could avoid it.

According to the IASB's draft documents, the decision in ED 2010 was that "*the lease term should reflect an entity's reasonable expectation of what the term would be*" (ED 2013.BC138) and, consequently, that the liability should be recognized based on that term. ED 2010 clarifies that the probable term should be the longest term with that level of probability. This is because the most likely criterion is relevant when there are two possible scenarios to choose from. If there are more scenarios, a cumulative approach should be used, which is the longest period for which the sum of the probabilities of that scenario and others with longer terms is greater than 50%.

ED 2013 changes the previous criteria towards a narrower view of the concept of liability, according to which the liability should be recognized if there is an economic incentive to exercise the option for which the term is extended (or the option for which it can be terminated early is not exercised). Among the criticisms of the proposals, ED 2013 reflects different views. Some of these are consistent with the limited concept of liability: "*some said that determining the present value of lease payments on the basis of the most likely lease term might result in the recognition of a liability (for the lessee) and an asset (for the lessor) that does not meet the definition of a liability or an asset in the boards' respective conceptual frameworks*" (ED 2013.BC139.a). Others took an intermediate view of the concept of a liability: "*some suggested increasing the threshold at which an entity would include options to extend in the measurement of lease assets and lease liabilities. They suggested thresholds such as 'reasonably assured' (used in existing US GAAP), 'reasonably certain' (used in existing IFRS) and 'virtually certain' (which would be a higher threshold that would almost equate to including only contractual minimum lease payments in the measurement of lease assets and lease liabilities)*" (ED 2013.BC139.c). It is the latter that was ultimately adopted in the proposal: "*The boards note that applying the concept of 'significant economic incentive' would provide a threshold that is similar to the concepts of 'reasonably assured' and 'reasonably certain' in existing US GAAP and IFRS, which the boards understand work well in practice. However, there would need to be a significant economic incentive for the lessee to exercise the option in order to include optional periods in the lease term. An expectation of exercise alone (and without any economic incentive to do so) would not be sufficient*" (ED 2013.BC140).

The IASB's response was reasonable at a time when the *Discussion paper 2013/1 - A Review of the Conceptual Framework for Financial Reporting* (DP 2013) on the reform of the conceptual framework was discussing the scope of the concept of liabilities and ruled out the strict view *a priori*. However, there were doubts as to whether to adopt the intermediate view (obligations for which there is no practical ability to avoid) or the broader view.

In the end, IFRS 16 adopted the intermediate view of the liability concept but reformulated it in the same terms as in IAS 17, as the standard links the term reasonably certain to the existence of an economic incentive. All this implies an individual analysis of each component of the contract under the sieve of the practical non-cancellability criterion.

Another issue related to the non-cancellability of a lease is the inclusion of termination clauses for both or either of the parties. According to IFRS 16.B34, the lease is cancellable if both parties can terminate the lease with no more than an insignificant penalty. However, if this option is available only to the lessor, IFRS 16.B35 considers the additional period that the lessor may require to be the lease term. This requirement appears to be based more on the strict view of the liability concept, as the lessee cannot avoid such a payment, rather than the intermediate view, which would have required an assessment of whether such an extension is reasonably certain to occur or the broader view, which is consistent with the contingent nature of the liability for the lessee and, therefore, the accounting for provisions. This interpretation would have considered the period in which it is "more likely than not" that the lessor would extend the lease as the lease term and would have been consistent with the measurement of provisions in IAS 37.

In our view, the passages in IFRS 16 that refer to the probability threshold in term options and fixed payments in substance seem to respond to the thesis of Kabir & Rahma (2018), according to which the standard provides concrete guidelines to provide certainty to stakeholders in international standards on the application of substance over form, while also avoiding the structuring of contracts. This could be interpreted as the standard moving from principles to rules; however, if these principles had been explicitly stated, better conceptual guidance would have been given provided on how to apply the concept of liabilities in this context.

b) The scope of economic compulsion: substance over form

Economic compulsion means that economic considerations strongly influence a decision, and the party under economic compulsion has no real freedom to choose between different alternatives. A faithful presentation must consider the effect of economic compulsion to show substance over form.

In 2019, the IFRIC received a consultation over the interpretation of the term penalty: "*the lease is cancellable when both parties can terminate the lease, incurring no more than an insignificant penalty*" (IFRS 16:B34). In this case, it was doubtful whether the "*insignificant penalty*" could be equated to economic compulsion. A strict interpretation of the concept of liability would lead to the conclusion that the lessee is not obliged to terminate the lease because it has the right to do so; however, an intermediate interpretation of the concept of liability would also be similar to the situation where there is a non-insignificant economic penalty or incentive to exercise the termination option. The IFRIC argues that an economic penalty should also be understood as an economic incentive, in line with the intermediate view of the liability embodied in IFRS 16 (IFRIC, 2019).

This decision also implies that the cases where both parties have the right to terminate the contract are similar to the case where both parties can tacitly renew the contract. However, this was not included in the wording of paragraph IFRS 16.B34 when it states:

> "*If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease (or the initial period of a renewable lease), it then applies paragraphs 19 and B37-B40 of IFRS 16 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.*" [emphasis added] (IFRIC, 2019).

4.2.3. The accounting treatment of variable lease payments

Variable lease payment clauses emerged as a relevant issue from the early G4+1 documents. Indeed, Nailor & Lennard (2000) argue that the rationale for addressing term options is similar to that required for variable clauses linked to the use of the leased asset because they involve the "purchase of more" time (term options) or use (variable payment clauses) of the assets. This argument justifies considering these clauses as future events and raises the question of whether the event is considered future when variable payments are intended to adjust the price (such as inflation and performance-based adjustments). Index-linked clauses involve the payment of an unspecified amount rather than the purchase of more of the asset. On the other hand, performance-based variable payments, however, aim to address the effects of information asymmetry, specifically adverse selection, where the lessor possesses information about the asset's cash flow-generating capability that the lessee does not have, or moral hazard, where the cash flows of the leased asset depend on the lessor's behavior.

From 2019, the first year of application of IFRS 16, the IASB analyzed two issues related to variable payments. Due to COVID, many lessees were relieved of their payments, and the conceptual interpretation was to consider them as negative variable clauses. The second issue was a consultation on variable lease payments on sale and leaseback transactions. The following is a summary of the debate that took place during the due process on variable consideration, followed by a discussion of the two issues that the IASB has analyzed in this regard.

a) The debate over variable considerations prior to IFRS 16 adoption

The conceptual interpretation of variable consideration has indeed been a highly contentious issue. It was initially identified in the G4+1 documents and subsequently revisited in several draft papers preceding the development of IFRS 16. The following sections of this paper will delve into various decisions made by the Board and IFRIC. It is important to note that the arguments presented were developed throughout the due process of IFRS 16.

DP 2009 brought attention to the conflicting perspectives on the concept of liability. One viewpoint suggests that liability should represent a reasonable depiction of the cash flows that will be sacrificed for events that have already occurred. The other, stricter viewpoint argues that liability exists only if the obligation cannot be avoided. In DP 2009, the dominant proposal analyzed various clauses of the contract comprehensively, including term options. It advocated for a broader interpretation of the liability concept, whereby variable payments were estimated and incorporated into the measurement. According to this perspective, the lease liability exists as a result of signing the contract. In contrast, the alternative viewpoint proposed a differentiation between clauses that can be avoided by the lessee (related to usage or performance) and those that cannot be avoided (linked to an index). In this approach, the contract may give rise to a set of obligations or expected obligations for the lessor, with only the former being recognized and the latter not being recognized as liabilities.

ED 2010 clarifies the broader interpretation of liabilities. It addresses the issue of variable payments by shifting it from a recognition decision to a measurement decision. This means that the avoidability of payments does not prevent them from being considered in the measurement of the liability that already exists due to the signed contract. In this document, the IASB states that the objective of the solution is to avoid the structuring of contracts. In our opinion, this would be justified only if the purpose were to prioritize substance over form and provide a more faithful representation of the information.

However, as in the case of term clauses, the proposal for variable payment clauses changes significantly in ED 2013. The liability view is narrowed, and performance or usage-based clauses were analyzed as separate elements in the recognition decision, distinct from the main contract. There were two primary reasons behind this proposal, which the Board members partially accepted. The first reason was the complexity involved in estimating the costs associated with such clauses, as the benefits obtained from these estimates were deemed to be outweighed. The second reason was the uncertainty surrounding whether these clauses met the definition of an asset (right of use) and liability (lease liability), especially considering that some of them were avoidable. In this case, these clauses were recognized as expenses when the future events leading to the payments became known. Only if these payments were fixed in substance would they be included in the initial measurement, ensuring a faithful representation of the information. This dual reasoning is based on different interpretations of liabilities. If the argument is that estimating the value of the liability is challenging, it implies that the liability exists because the delivery of cash is probable (broad view). On the other hand, if the argument is that the obligation is not a liability due to its avoidability, it aligns with a restricted view of liabilities (strict view).

On the other hand, variable payment clauses tied to an index cannot be avoided. Due to the complexity of estimating future rates, these clauses are considered liabilities, and the rate in effect at the inception of the contract is used. Concerning index-linked clauses, IFRS 16 adopts the criterion from the ED 2013 with a slight nuance: future payments are revised when the historical value of the reference index becomes available. Any modifications to these clauses, based on historical observations, lead to an adjustment in the value of the lease liability and the right-of-use asset.

A controversial issue in this context is whether performance-related clauses should be considered avoidable. One argument suggests that performance is typically tied to the intensity of asset usage, implying that a liability would arise if the decision is made to continue using the asset. IFRS 15, dealing with sales contracts with customers, addresses this information asymmetry by requiring the estimation of variable consideration, resulting in the recognition of an asset (positive premium) or liability (negative compensation) arising from a past event. In our perspective, these clauses exist at the inception of the lease contract and, akin to sales contracts, could have been considered in lease accounting, subject to the condition that no significant reversal of income will probably occur. Alternatively, the complexity of calculating these clauses, which some Board members cited as the primary reason for their exclusion from lease payments, could be acknowledged. However, it should be clarified that these clauses are not avoidable by the lessee, distinguishing them from other avoidable elements in lease contracts.

The decision not to classify certain clauses as liabilities is not supported by all members, indicating a lack of unanimity regarding this conceptual change. The solution adopted, similar to the treatment of term clauses, raises concerns about the integral analysis of contracts. Analyzing each clause individually to determine its classification as a liability transforms it into a recognition decision rather than an integral part of the liability measurement process. According to the intermediate view in the conceptual pronouncement issued in 2018 with the approval of the CF, the entity should not recognize the clause as a lease liability if it is avoidable. However, the lack of consensus within the Board on this criterion reveals that the concept of a liability required a conceptual pronouncement. IFRS 16's position aligns with the intermediate view of the concept of liabilities, which necessitates examining the economic substance beyond the contractual form. This approach ensures that the reported information provides a faithful representation of the commitments undertaken by the entity.

Another situation that could give rise to some controversy in the application of the concept of liability is the case of variable payments that depend on the lessor. For example, a clause providing for variable rentals based on footfall in a shopping center. These clauses are intended to reduce the information asymmetry between the lessor and the lessee in assessing the cash flow-generating capacity of the underlying asset. In this sense, their function is similar to that of variable payments based on the performance of the asset. However, this variable payment is not dependent on the lessee, as is the case with payments based, at least in part, on the sales of a store, as recognized by the AAA Financial Accounting Standards (Ryan et al., 2001). Therefore, as the lessee cannot avoid them, they should be included in the measurement of the liability, provided that the measurement is sufficiently reliable to give a faithful representation of the liability.

b) Lease revisions: reduction of future payments

As a result of COVID-19, lease payments were renegotiated between lessors and lessees. Lessees had to analyze whether these changes were modifications or new circumstances affecting the original contract. To facilitate this decision, the IASB proposed a practical expedient that allows lessees to consider that the change in liability is not a contract modification (IASB, 2020a: IFRS 16.BC205A). Rent concessions were based on the aphorism "*rebus sic stantibus*" and that serious changes in circumstances could justify an imbalance of commitments between the parties to the lease. Tenants could challenge this imbalance in court, which was likely to be upheld. This is where the importance of the legal framework for interpreting contracts comes into play. This line of argument implies that legislation and jurisprudence incorporate into the regulatory framework of an agreement a clause of a contingent nature, consisting of the ability of the authority having jurisdiction to reduce the amount to be satisfied (a usage-variable clause of a negative nature). The IASB has decided that the counterpart of this reduction in the liability should be recognized in profit or loss, as in the case of variable usage-based payments. There are two reasons for this accounting treatment: first, they are avoidable; second, they are difficult to measure reliably. This solution seems to be based on rules (variable lease payments based on the use of the asset are recognized in profit or loss) rather than principles (clauses that the lessee can avoid are recognized in profit or loss). Regarding this matter, François Flores, one of the IASB board members, emphasized in her vote on the proposed amendment to IFRS 16 for sale and leaseback transactions (IASB, 2020c) that "*in the circumstances that have arisen during the covid-19 pandemic, seller-lessees exposed only to payments linked to future performance would, in accordance with the accounting proposed in the Exposure Draft, record a gain if their activities cease. In Ms Flores' view, such a gain would be an unfair reflection of their economic performance.*". We believe that this reasoning is also applicable to all leases, as the cessation of activity and payments would result in a gain that does not provide a faithful representation of economic performance.

In our opinion, we consider that it is indeed an implicit clause of a variable and negative nature: it allows the lessee to pay less, but this variable clause does not depend on the lessee's discretion but is imposed by circumstances. The fact that it is linked to the use of the asset does not make it avoidable. Clauses related to usage are recognized as an expense because they are avoidable. This is relevant because, to be consistent with this type of non-avoidable clause (those relating to an index), an adjustment should have been made to the value of the asset rather than recognizing income in the income statement.

The adjustments to the rents payable should not have been recognized as income in the income statement because the liability was extinguished without being settled. However, the asset should have been derecognized as it was no longer under control (i.e., the closure prevented the lessee from using the asset, or only allowed usage under highly restricted conditions). However, the solution adopted was to test the asset for impairment. In our view, this solution was inconsistent with the nature of the clause and the conceptual reasons for excluding variable clauses based on use from lease liabilities. These clauses were excluded because the lessee can avoid making variable payments based on usage. In this scenario, the lessee had no control over the reduction in payments; it depended on circumstances, as in the case of indexed variable payments. In addition, the solution seems to confuse derecognition and impairment. This issue may be revisited in the post-implementation review of IFRS 16.

c) Variable clauses in sale and leaseback transactions

A second issue relates to sale and leaseback transactions, where the leaseback includes variable payments. For example, an entity sells an asset for 1,000 c.u. The carrying amount is 700 c.u. At the same time, the buyer leases the asset back to the former seller for ten years and the compensation is 3% of total revenues, depending on the performance of the asset. Under IFRS 16, the seller is required to derecognize part of the asset because it obtains control of the asset through the lease arrangement. The proportion of the asset retained refers to the percentage of the asset's value that remains with the seller-lessee. This percentage is calculated by dividing the present value of the lease payments by the fair value of the asset. In cases where the payments are contingent upon performance, the lessee should not recognize a liability if it can avoid it, and the seller, having fully transferred the asset, recognizes the proceeds from the sale (300 c.u). If the entity estimates a liability to avoid recognizing the full amount of income, it would result in the lessee recognizing a liability that it could potentially avoid.

Initially, it was decided not to add the issue to the agenda, but after discussion, the Board concluded that there was a need to include guidance on the measurement of leaseback sales and an exposure draft of an amendment to IFRS 16 was issued (IASB, 2020c).

Sale and leaseback transactions that meet the criteria of a sale in IFRS 15 are required to recognize the sale for the proportion of services transferred to the buyer-lessor. This proportion is the value of the portion of the services not retained by the seller-lessee. The proportion of services retained is the ratio of the present value of the contractual lease payments to the fair value of the leased asset at the inception of the lease. If the lease payments are fully variable, the retained interest in the asset is zero and the gain on disposal of the entire asset should be recognized. This solution is counterintuitive and seriously compromises the model.

The IASB has initially decided to consider that, to calculate the proportion of services retained by the seller-lessee, the lease liability should include fixed payments, variable payments related to an index, and fixed payments in substance, but not the estimate of payments to be made for other variable payments not mentioned above. The denominator would be the fair value of the asset sold. Including variable payments solely for the purpose of determining the gain or loss to be recognized is puzzling, given the ongoing doubts about their classification as liabilities and the inherent complexity in estimating them. These concerns have prompted François Flores, a member of the Board, to cast an individual vote on the Exposure Draft (IASB, 2020c), supporting these arguments. Mrs. Flores also highlights that such a transaction transfers the technological risk from the seller-lessee to the buyer-lessor, as the seller-lessee would not be required to make payments to the buyer-lessor if the asset ceases to function. It is worth noting that Mrs. Flores completed her term in 2021 and did not vote on the final amendment to the Standard.

The argument in favor of the Board's solution is based on the criticism of a strict interpretation of the liability concept. According to this interpretation, a contract without options or variable payments would be accounted for in the same way as one with options or variable payments, even if they are economically different. Theoretically, this difference could be captured by valuing these components separately at fair value. However, this approach was initially discarded (DP 2009), although it was considered in the second G4+1 report (Nailor & Lennard, 2000). Nevertheless, it has been revived in the context of estimating the lease liability in a sale-leaseback transaction with variable payments.

The approved amendment to IFRS 16 for sale and leaseback transactions also included a dissenting opinion from Nick Anderson, a member of the IASB. Although he did not object to the Exposure Draft, he changed his opinion and now prefers the seller-lessee to recognize the full gain or loss from the transaction immediately. Some respondents also shared this view on the draft amendments (IASB, 2022:16). Mr. Anderson's position raises questions about the accounting treatment of sales and leaseback transactions and argues that this amendment further entrenches these requirements. His main objection is that the results of these transactions stem from disposals, and the amount of the gain and loss corresponding to the retained right-of-use should be treated as deferred disposal income. Mr. Anderson asserts that users should differentiate between the results of disposals and other operating items. Under this proposed approach, the deferred income would be linearly allocated throughout the leaseback term, and during this period, the entity would recognize variable payments as expenses. This perspective primarily focuses on the sale component of the contract, and we agree with this viewpoint since the solution to these transactions can be found in IFRS 15.

In our opinion, an alternative approach can be based on considering these transactions as a combination of two contracts that are traded together. If the variable component of the remuneration is related to the sale transaction, the liability would need to be estimated. The variable prices associated with the sale should be subject to estimation, taking into account the constraint that it is highly probable that there will be no significant reversal. The level of uncertainty regarding variable prices is less restrictive compared to in-substance fixed lease payments, which also need to be estimated. Therefore, the inclusion of a variable rent clause could be seen as an adjustment of the sale price, considering it as a variable payment. In this interpretation, any variable lease payment would reduce the sale price. Linking the two transactions (sale and leaseback) allows for analysis from the perspective of the sale or leaseback involved. In this particular case, the variable consideration of the sale transaction determines the liability through variable lease payments.

5. Conclusions

IFRS 16 arose to address a lack of information about the liabilities of lessees. During the due process, there was strong opposition, especially from the preparers, and the deliberations were not solely based on conceptual positions. Based on a historical reading of the deliberations, this study identifies the criteria underlying the definition of liabilities contained in the standard. Against this background, this paper examines the interpretations given by the IFRIC and the IASB to various consultations received after the implementation of the standard in relation to the interpretation of the concept of liabilities. In our opinion, IFRS 16 is a standard that has not always been interpreted in accordance with the principles that inspired it. Our analysis shows that the standard and the basis for its conclusions have needed clarification or, in some cases, have been interpreted in a way inconsistent with the criteria under which IFRS 16 was issued.

This paper highlights the need for a more explicit interpretation of the concepts, either in the standards or the doctrinal literature, because otherwise, the standards may abandon their principles-based regulatory vocation. Our findings are relevant to standard setters and, to a lesser extent, preparers and auditors who must apply the standard. The conclusions can be summarized as follows and may be particularly relevant to the IASB in its upcoming post-implementation review of IFRS 16.

In relation to the concept of obligation within lease liabilities, based on our analysis, we believe there is a need for clarification either within the lease standard itself or within the Basis for Conclusions. As a result, we propose the following considerations:

- Clarify that the lease obligation arises from the contracts as interpreted in the corresponding jurisdiction.
- Exclude the derecognition of lease receivables and liabilities from the scope of IFRS 9 and address them specifically under IFRS 16, which governs the modification of lease contracts. This is important because lease liabilities, like trade payables, arise from transactions related to the acquisition of operating assets.
- Specify that the lease liability pertains to the liability established in the relationship with the supplier (lessor) since the lessor acts on their own account. It should not include associated obligations, such as tax liabilities, which are separate from the lease agreement and considered non-lease payments.

When applying the past events criterion, particularly in the context of executory contracts and complex leases, our analysis leads us to make the following considerations:

- Review the treatment of non-consecutive rights of use as they involve multiple deliveries by the lessor. Treating them as a single lease ignores the rationale of the right-of-use model, namely, that the lessor has fulfilled its obligation by delivering the asset.
- Reassess the requirement for the existence of a substitution right throughout the lease term. If the right of substitution is substantive for only part of the lease term, it should limit the lease term to the period during which the supplier lacks a substantive right of substitution. This reflects the economic reality of two transactions coexisting under the same contract: a supply of services and a lease.
- Consider amending paragraph IFRS 16.B35 after analyzing the requirements for term clauses. When only the lessor has the ability to terminate the lease, the period to be considered should be the best estimate ("more likely than not"), consistent with the treatment of any contingent liability as per IAS 37.
- Clarify paragraph IFRS 16.B34 by replacing "no more than an insignificant penalty" with "without any economic incentive," as decided by the IFRIC. Additionally, clarify that the lease is non-cancellable when both parties can tacitly renew it, even though it may not be explicitly stated in paragraph B34.
- Specify that the difference in treatment between indexed and performance-based variable payments is determined by the lessee's ability to avoid the payments. Also, subjectivity in the estimation could affect both types and, if very high, would prevent the recognition of the value of these payments in measuring the lease liability. With this principle in place, modifications to contracts due to a contractual interpretation of the cause of major force in the jurisdiction that leaves the contract without effect for a period of time are variable rents of a negative nature. In this case, it does not need to be estimated initially because it is a remote event. If it occurs, it is beyond the lessee's control; therefore, the adjustment would be similar to that for index-linked clauses where the lessee cannot avoid the payment. In other words, the value of the right of use that ceases during that period should be credited.
- Finally, regarding variable payments in sale and leaseback transactions, there have been concerns about the recognition of excessive gains on sales. In our view, IFRS 15 should guide the interpretation of recognizing such gains on sale. According to this standard, the expected variable payments should be included in the estimate of the sale price, and those expected payments would be recognized as a contract liability. This interpretation aligns with the principle in IFRS 16 that variable payments linked to use or performance (not fixed payments in substance) should not be recognized as part of the liability.

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Conflicts of interest

The authors declare that they have no conflicts of interest.

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