Comment Letter (Drafting recommended by EFRAG TEG)

International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

XX April 2021

Dear Mr Hoogervorst,

Re: Lease Liability in a Sale and Leaseback

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2020/4, *Lease Liability in a Sale and Leaseback,* issued by the IASB on 27 November 2020 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

EFRAG considers that there is a broader issue to consider by the IASB as there exists conflict between two main principles in IFRS 16:

- the exclusion of variable lease payments (not based on an index or rate) from the definition of lease payments, and
- the principle that when entering into a sale and leaseback transaction there should not be any gain on the interest retained by the seller-lessee.

EFRAG notes that the ED would result in a seller lessee recognising a gain only to the proportion of the rights it has transferred to the buyer-lessor. EFRAG believes that recognising the full gain or loss on the sale would not have reflected the economics of a sale and leaseback transaction. EFRAG is concerned that the proposals in this ED may lead to further inconsistency arising from the use of two different definitions of variable lease payments if they are not accompanied with clear analyses and explanation of the reason for the discrepancy.

EFRAG therefore urges the IASB to reconsider the matter more broadly; possibly as part of the future Post Implementation Review of IFRS 16 or the IASB's research project on Variable and Contingent Consideration.

EFRAG accepts that a temporary and faster solution is put in place to address the lack of guidance in IFRS 16, pending a more holistic review of the matter.

EFRAG also notes that there are complexities and operational challenges associated with the proposals in the ED, in particular regarding the level of judgement involved in estimating the future variable payments. These matters are further described in the detailed response.

However, if the amendments resulting from the ED were to be finalised, EFRAG encourages the IASB to consider a simpler solution to achieve the same outcome, by recognising the present value of the expected variable lease payments as a non-lease liability or a deferred gain. This would result in lease contracts with the same characteristics being accounted for in the same way, irrespective of whether they were entered into directly or via a leaseback.

Under this alternative, the IASB could further explore a possible approach for subsequent measurement that would release the non-lease liability on a straight-line basis over the expected term of the leaseback. This would be similar to the approach that existed in the predecessor standard to IFRS 16 which recognise in profit or loss the difference between the expected and the actual variable payments when they materialise. This approach, although temporary by nature, would be reassessed at a later stage, when the IASB completes the review of the conflict of principles that is mentioned above and the overall approach for sale and leaseback transactions.

Lastly, if the amendments were finalised, EFRAG also supports the proposed transition requirements and in particular the retrospective application of the proposed amendments, unless in circumstances where such retrospective application cannot be done without the use of hindsight.

EFRAG's detailed comments and responses to the questions in the ED are set out in the Appendix.

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions raised in the ED

Question 1 - Measurement of the right-of-use asset and lease liability arising in a sale and leaseback transaction

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The [Draft] amendment to IFRS 16 *Leases* applies to sale and leaseback transactions in which, applying paragraph 99 of IFRS 16, the transfer of the asset satisfies the requirements to be accounted for as a sale of the asset. The [Draft] amendment proposes:

(a) to require a seller-lessee to determine the initial measurement of the right-of-use asset by comparing the present value of the expected lease payments, discounted using the rate specified in paragraph 26 of IFRS 16, to the fair value of the asset sold (paragraph 100(a)(i));

(b) to specify the payments that comprise the expected lease payments for sale and leaseback transactions (paragraph 100A); and

(c) to specify how a seller-lessee subsequently measures the lease liability arising in a sale and leaseback transaction (paragraph 102B).

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why?

EFRAG's response

EFRAG considers that the ED provides evidence of the existence of a broader conflict of principles in IFRS 16 to regarding the accounting for sales and leaseback and the definition of lease payments. Therefore, EFRAG encourages the IASB to consider the issue more comprehensively and in a timely manner, possibly as part of the upcoming Post-implementation review of IFRS 16 or the IASB's project on Variable Consideration.

Pending such a more fundamental review, EFRAG can accept the proposed accounting in the ED as a temporary, faster, but not necessarily perfect solution to address the lack of guidance in IFRS 16 on the accounting of sales of leaseback with variable payments.

Finally, EFRAG also notes operational challenges associated with the proposals in the ED that would require further consideration and guidance.

1 EFRAG considers that the ED provides evidence of the existence of a fundamental conflict of principles between two main principles:

(a) the exclusion of variable lease payments (not based on an index or rate) from the definition of lease payments for the initial measurement of standalone leases; and

(b) the principle that when entering into a sale and leaseback transaction there should not be any gain on the interest retained by the seller-lessee; which, in turn, leads to the inclusion of such variable payments in the initial measurement of the lease liability and the right-of-use asset.

2 This existing conflict of principles calls for a more fundamental review of the accounting requirements in IFRS 16. In that respect, EFRAG observes that the initial measurement of the lease liability arising from the leaseback is a consequence of how the gain or loss on the sale and leaseback transaction is determined applying

paragraph 100(a) of IFRS 16. This initial measurement (and the definition of lease payment that underpins that measurement) differs from the measurement of the liability of a 'standalone' lease (that is a lease not entered into as part of a sale and leaseback transaction).

3 EFRAG is concerned that the proposals in this ED may lead to further inconsistency arising from the use of two different definitions of variable lease payments if they are not accompanied with clear analyses and explanation of the reason for the discrepancy.

4 Nevertheless, EFRAG can accept the proposed accounting in the ED as a temporary, faster, and not necessarily perfect solution to address the lack of guidance in IFRS 16 pending a more holistic and fundamental review of the matter.

5 Requiring seller-lessees to initially measure the right-of use asset and lease liability arising from a leaseback in the same way as standalone leases would have resulted in seller-lessees recognising the full gain or loss on the sale of the asset. EFRAG believes that recognising the full gain or loss on the sale would not have reflected the economics of a sale and leaseback transaction.

6 EFRAG notes that the ED would result in a seller lessee recognising a gain only to the proportion of the rights it has transferred to the buyer-lessor. However, EFRAG urges the IASB, if the amendments were to be finalised, to consider a simpler temporary solution to achieve the same outcome by recognising a non-lease liability or a deferred gain. This would result in lease contracts with the same characteristics being accounted for in the same way, irrespective of whether they were entered into directly or via a leaseback.

7 Under this alternative the non-lease liability would be released on a straight-line basis over the expected term of the leaseback similar to the accounting that existed in the predecessor standard to IFRS 16[1]. EFRAG is cognisant that such an alternative would lead to a significantly different subsequent accounting in the statement of income from the proposals in the ED; as it will result in:

(a) Expensing all variable lease payments incurred over the lease period; (under the ED proposals, such payments would be reallocated as repayment of the lease liability principal and accrued interest expense);

(b) Accounting for the release of the deferral on a straight-line basis as income; and

(c) Amortising the right-of-use asset (similar in both alternatives).

8 This approach, although temporary by nature and not necessarily perfect could be reassessed at a later stage after the IASB completes the review of the conflict of principles that is mentioned above and the overall approach for sale and leaseback transactions.

Operational challenges to consider

9 EFRAG considers that the following operational challenges should be contemplated:

(a) The level of judgement involved in estimating the lessee's future performance or the use of the underlying asset on which future variable payment are estimated;

[1] Under IAS 17 *Lease,* for a sale and leaseback transaction that results in a finance lease, any excess of proceeds over the carrying amount is deferred and amortised over the lease term.

(b) The determination of an appropriate discount rate considering the specificities of variable payments linked to future performance or use of the underlying asset in terms of higher uncertainties that affect cash flows;

(c) The fact that the future variable lease payments are not subsequently reassessed to reflect changes in estimates; meaning that, the latest estimate of expected cash outflows will not be reflected at the end of each accounting periods.

10 EFRAG therefore recommends that the IASB considers further application guidance and disclosures in these areas.

11 EFRAG observes, in that regard, that paragraph 59(b) of IFRS 16 requires lessees to disclose information to help users understand '*future cash outflows to which the lessee is potentially exposed <u>that are not reflected in the measurement of the lease liabilities</u>. This includes exposure arising from variable lease payment''.*

12 EFRAG suggests that the IASB consider clarifying that information should also be provided for variable lease payments not based on an index or rate that are included in lease liabilities as a result of a sale and leaseback transaction.

13 EFRAG acknowledges that IAS 1 *Presentation of Financial Statements* already requires disclosure of information about the assumptions the entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. We however consider that the more specific guidance included in paragraph 59(b) would usefully clarify the type of information needed for variable payments not based on an index or rate, (in particular 'key variables upon which variable lease payments are expected to vary in response to changes in those key variables).

Question 2 - Transition

Question 2 Transition

Paragraph C20E of the [Draft] amendment to IFRS 16 proposes that a seller-lessee apply the [Draft] amendment to IFRS 16 retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors to sale and leaseback transactions entered into after the date of initial application of IFRS 16. However, if retrospective application to a sale and leaseback transaction that includes variable lease payments is possible only with the use of hindsight, the seller-lessee would determine the expected lease payments for that transaction at the beginning of the annual reporting period in which it first applies the amendment.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

EFRAG's response

If the proposed amendments are finalised, EFRAG also supports the proposed transition requirements and, in particular, the retrospective application of the proposed amendments, unless in circumstances where such retrospective application cannot be done without the use of hindsight.

14 If the amendments are finalised, EFRAG supports the retrospective application of the proposed amendments as it makes information more comparable.

15 EFRAG notes that although the proposed amendments apply to all sale and leaseback transactions occurring after the initial application of IFRS 16 (i.e., 2019), it is expected to primarily affect leasebacks that include variable lease payments.

Therefore, for most seller-lessees, the proposed amendment would affect only sale and leaseback transactions occurring from 2019 that include variable lease payments.

16 EFRAG agrees that in some circumstances, retrospective application may not be possible without the use of hindsight. This is because retrospective application would require the seller-lessee to estimate the expected lease payments at the commencement date of the sale and leaseback transaction.

17 Therefore, we support the specific transition requirements contained in the ED to avoid the use of hindsight and ensure seller-lessees apply the same approach if those circumstances arise.