

Draft Comment Letter

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Comments should be submitted by 22 February 2021

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

22 December 2020

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 observes that the proposed amendments would not result in changes to the existing measurement requirements in IFRS 16 applicable to all leases but rather explain how to apply the existing principles to leases arising in the context of sale and leaseback transactions that have variable payments not based on an index or rate.

EFRAG supports the proposals in the ED as they provide guidance on an area not currently addressed by the IFRS 16 and have the potential to reduce diversity in practice, while relying on principles that have been assessed to result in relevant information.

In particular, the proposals in 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 notes that there are operational challenges associated with the proposals in the ED, in particular the level of judgement involved in estimating the future lease payments. To address the matter, EFRAG suggests the IASB to consider additional disclosures regarding the judgement applied in estimating the future payments, such as how these estimates impact the measurement of the right-of-use assets and lease liability, and their sensitivity to the assumptions used.

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.

IASB ED Lease Liability in a Sale and Leaseback

While being supportive of the proposals in the ED, EFRAG acknowledges that there may be 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 therefore encourages the IASB to reconsider the matter more broadly as part of the future Post Implementation Review of IFRS 16.

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

If you would like to discuss our comments further, please do not hesitate to contact Hocine Kebli, Joachim Jacobs or me.

Yours sincerely,

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

Notes to constituents – Summary of the proposals in the ED

- 1 *The proposed amendment would apply to all sale and leaseback transactions in which the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 with lease payments at market rates.*
- 2 *Applying the ED, a seller-lessee would:*
 - (a) *Initially measure the right-of-use asset arising from a leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee; and recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor;*
 - (b) *Determine that proportion and the initial measurement of the right-of-use asset and lease liability using the present value of expected lease payments (including all payments regardless of whether they meet the definition of lease payments);*
 - (c) *Subsequently measure the lease liability consistently with its initial measurement, that is including all payments regardless of whether they meet the definition of lease payments; and apply the provisions in Paragraphs 36-38 of IFRS 16 by:*
 - (i) *increasing the carrying amount to reflect interest on the lease liability;*
 - (ii) *reducing the carrying amount to reflect the lease payments made; and*
 - (iii) *remeasuring the carrying amount to reflect any reassessment or lease modifications specified in paragraphs 39-46, or to reflect revised in-substance fixed lease payments;*
 - (d) *Do not remeasure the lease liability to reflect a reassessment of future variable lease payments. Instead, any difference between the actual variable payments made and those what were expected in the initial measurement of the lease liability are charged to profit or loss when incurred (in agreement with paragraph 38 of IFRS 16).*

In case of lease modifications, a seller-lessee should account for that modification, applying paragraphs 40 and 45 of IFRS 16, by remeasuring the lease liability, discounting the revised expected payments for the lease using a revised discount rate at the date of the modification. It would be inappropriate to remeasure the lease liability to zero, on the basis that the leaseback payments do not meet the definition of lease payments.

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

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 supports the proposals in the ED as it provides guidance on an area not currently addressed by the IFRS 16 and can reduce the potential for diversity in practice, while relying on existing measurement principles, applicable to all leases, that have been assessed to result in relevant information.

Nonetheless, EFRAG acknowledges that there may be a broader issue to consider by the IASB as there is a 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.**

Although we agree that the latter principle is given precedence, EFRAG encourages the IASB to reconsider the matter more broadly possibly as part of the future Post Implementation Review of IFRS 16.

EFRAG also notes operational challenges associated with the proposals in the ED and in particular the significant judgement involved in estimating the future lease payments. To address the matter, EFRAG suggests that the IASB consider disclosures regarding the estimates of future lease payments.

- 3 EFRAG first observes that the proposed amendments would not result in changes to the existing underlying principles or existing requirements in IFRS 16 applicable to the accounting for a 'standalone' lease (that is a lease entered into outside of a sale and leaseback transaction).
- 4 Instead, the proposed amendments explain how to apply existing principles to leases arising in the context of sale and leaseback transactions that have variable payments not based on an index or rate.
- 5 In particular, the proposals in 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.
- 6 EFRAG therefore supports the proposals in the ED as they provide guidance on an area not currently addressed by IFRS 16 and can reduce the potential for diversity in practice while relying on principles that have been assessed to result in relevant information when IFRS 16 was finalised.
- 7 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 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).

- 8 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 and would not have reflected the economics of a sale and leaseback transaction.
- 9 EFRAG however consider that the ED provides evidence of the existence of a 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.
- 10 Although, as mentioned above, EFRAG welcomes the proposed amendments in the ED, we would like to encourage the IASB to reconsider this conflict of principles more broadly possibly as part of the future Post Implementation Review of IFRS 16.

Questions to Constituents

- 11 Do constituents agree that the difference in the initial measurement of a lease liability arising from a leaseback and the liability arising from standalone leases is justified? If you disagree with the proposal, please explain what you suggest instead and why?

Operational challenges to consider

- 12 EFRAG considers that the following operational challenges should be considered:
- 13 Calculating the gain on the sale of the asset at the date of transaction; and
- 14 Estimating the future sales on which lease payments were based under the contract for longer periods.
- 15 In that regard, EFRAG does not fully agree with the statement made in the proposed basis for conclusions paragraph BC19 that 'the Board expects that seller-lessees would be able to reasonably estimate the expected lease payments because '... a seller-lessee owns and controls the underlying asset until the sale and leaseback transaction. Seller-lessees should therefore have access to information that would enable them to reasonably estimate the fair value of the underlying asset and the expected lease payments.'
- 16 The above statement might be true in case of variable payments based on the specific usage of the lease asset. However, in situations whereby the lease payments are based on the turnover of the seller lessee (as in the original fact pattern considered by the IFRS Interpretations Committee that led to the ED) to develop reasonable estimates might be more complex. The proposed statement in paragraph BC19 seems also to contradict the existing paragraph BC10 which state that '*it would be extremely difficult in many cases to estimate variable lease payments if the amounts depended on future sales or use of the underlying asset and that such estimates would be subject to a high level of measurement uncertainty*'.

Need for Disclosures

- 17 EFRAG observes 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 that are not reflected in the measurement of the lease liabilities. This includes exposure arising from variable lease payment”.

- 18 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 transactions.
- 19 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.
- 20 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

Notes to constituents – Summary of the proposals in the ED

- 21 *The ED provides that a seller-lessee shall apply the proposed amendments retrospectively in accordance with IAS 8 to sale and leaseback transactions entered into after the date of initial application.*
- 22 *However, if retrospective application to a sale and leaseback transaction that includes variable lease payments would be possible only with the use of hindsight, the seller-lessee shall determine the expected lease payments for that transaction at the beginning of the annual reporting period in which the seller-lessee first applies the amendment. In such circumstances, the seller-lessee shall:*
 - (a) *measure the lease liability arising from the leaseback at the present value of the remaining expected lease payments at the date of initial application of the amendment;*
 - (b) *measure the right-of-use asset arising from the leaseback at its carrying amount as if the amendment had been applied since the commencement date, but measured using the remaining expected lease payments at the date of initial application of the amendment plus the actual payments made for the lease until that date; and*
 - (c) *recognise the cumulative effect of applying the amendment as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application of the amendment.*

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

EFRAG 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.

- 23 EFRAG supports the retrospective application of the proposed amendments as it makes information more comparable.
- 24 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.
- 25 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.
- 26 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.