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29 March 2021

Dear Sir

Exposure Draft ED/2020/4: Lease liability in a Sale and Leaseback

We are pleased to comment on the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

We do not support the amendments proposed by the IASB. We believe that the introduction of new requirements for how an entity accounts for variable lease payments that apply to only leases arising from a specific subset of transactions is inconsistent with the conclusions the IASB reached when IFRS 16 was issued and it is also unnecessarily complex. We have proposed an alternative approach, which we believe results in the appropriate gain/loss being recognised at the time of the sale and leaseback, without introducing a new measurement model for leases.

Our responses to the questions in the ED are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)7875 311782 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Andrew Buchanan

Global Head of IFRS and Corporate Reporting

Appendix

Question 1 – 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.

We agree with the IASB's decision to develop requirements to limit the recognition of artificial gains in profit or loss that may arise if a sale and leaseback transaction is structured to contain significant variable lease payments. We note that these proposed requirements are intended to complement the agenda decision issued by the IFRS Interpretations Committee in June 2020, which explained how IFRS 16.100 is applied to result in a gain/loss that reflects the substance of the transaction entered into by the seller-lessee and buyer-lessor. The proposed requirements are intended to explain how the liability recognised by applying the agenda decision should be initially and subsequently measured.

However, we do not agree with the proposals for the following reasons:

1. The proposals are inconsistent with the conclusions reached by the IASB when it developed requirements included in IFRS 16; and
2. The proposals are unnecessarily complex.

We have explained these points further below. We have also included a proposed alternative approach, as well as suggested changes to the proposals if the IASB decides to proceed with the approach that has been proposed in the exposure draft.

<u>Inconsistency with Conclusions reached when IFRS 16 was Issued</u>

IFRS 16 requires lease payments to be accounted for differently depending on the nature of those payments. The distinction in the requirements is based on whether the lease payments are fixed or variable, and if variable, the nature of the variability (i.e. whether the variability arises from cash flows that depend on an index or rate). The nature of lease payments affects how those lease payments are accounted for. The IASB explained its rationale in the Basis for Conclusions to IFRS 16. This resulted in variable lease payments that do not depend on an index or rate being excluded from the initial and subsequent measurement of a lease liability and right-of-use asset.

The proposals in the exposure draft would result in a change to this fundamental conclusion in IFRS 16. A further distinction would be drawn in how lease payments are accounted for, however, this distinction would not relate to the nature of the lease payment (i.e. fixed or variable), but from the nature of the lease contract and the transaction that the lease is economically linked with.

Therefore, it is possible that two lease contracts that are identical in contractual terms may be accounted for differently. For example:

1. Lease payments are entirely variable based on turnover from a retail shop; and
2. Lease payments are entirely variable based on turnover from a retail shop and the lease originates from a sale and leaseback transaction.

Lease #1 would not be recognised in the statement of financial position due to the requirements of IFRS 16.27 and 38(b). Lease #2 would be recognised in the statement of financial position due to the proposed addition of IFRS 16.100A. We do not believe that the estimated lease payments in lease #2 are different in nature from those in lease #1 and, therefore consider that the conclusions reached by the IASB in issuing IFRS 16 should be applied when measuring the lease liability. We note that these conclusions were primarily driven by a cost-benefit analysis (IFRS 16.BC169). We do not believe the benefits of applying the model proposed in the exposure draft outweigh the additional cost, especially once the costs of introducing an additional measurement model in IFRS 16 are considered.

Complexity

IFRS 16.100A in the exposure draft would require a seller-lessee to estimate all lease payments, including variable lease payments that depend on an index or rate. IFRS 16.102B(d) in the exposure draft would require any difference between the actual payments made for the lease and the expected lease payments to be recognised as a variable lease payment (IFRS 16.38). This means that estimates made when a lease is initially recognised would be 'locked in' and the lease liability and right-of-use asset would not be adjusted for subsequent changes to those estimates.

Many sale and leaseback transactions occur when the underlying asset is real estate, which often have very lengthy lease terms (e.g. 10-20+ years). These types of leases also very often contain lease payments that depend on an index or rate such as CPI or inflation to ensure that the lease payments remain in line with changes in broad macro-economic factors. This is especially prevalent in jurisdictions where inflation rates are high, but not so high that IAS 29 is applied.

We believe that it could be very challenging for entities to estimate all lease payments over a very lengthy period when those payments are dependent on an index or rate. These indexes and rates often fluctuate significantly from year to year. This requirement is particularly problematic in that no change in the estimate may ever update the measurement of the lease liability and right-of-use asset, which differs from the requirement in IFRS 16.42(b). If significant changes in rates or indexes occur over the term of the lease, an entity's statement of financial position would not reflect its best estimate of liabilities as the requirements in the exposure draft would not permit an update to the measurement of the lease liability, which contradicts the requirement for other leases with payments linked to these types of index or rate.

Suggested Alternative Approach

Instead of introducing a new measurement model for a narrow subset of leases based on the nature of the transaction to which they relate, we propose an alternative approach.

Entities would still be required to determine the gain/loss relating to the sale and leaseback by applying the June 2020 IFRS Interpretations Committee agenda decision. The liability arising from the sale and leaseback would be characterised as a deferred gain, which would be recognised in income over the term of the lease. This reflects the fact that the seller-lessee cannot recognise the entire gain because it has retained a portion of its rights relating to the underlying asset. Any benefit from the sale and leaseback should therefore be recognised over the term of the lease rather than when control of the underlying asset is transferred.

Lease payments arising from the lease would be accounted for based on the existing requirements of IFRS 16.

We believe this approach achieves the appropriate balance of ensuring that artificial gains are not recognised in sale and leaseback transactions solely by virtue of how the lease payments are structured, while also balancing the complexity of the requirements and maintaining a consistent measurement model for all leases.

Suggested Changes to Proposals

If the IASB decides to pursue an approach largely consistent with the exposure draft as published, we would suggest certain changes be made to the requirements. We believe that IFRS 16.100A and 100B(d) should be amended to require estimates of variable lease payments based on an index or rate to be made initially, with them subsequently being accounted for in accordance with IFRS 16.42(b). As noted earlier in our response, we believe the complexity of requiring a 'locked in' estimate of all lease payments is too high, particularly for jurisdictions where lease terms are for extended periods of time and it is challenging to estimate long term inflation, CPI, etc.

Question 2 - 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.

We agree with the proposed transitional requirements if the IASB pursues a measurement approach consistent with the proposals in the exposure draft.