International Accounting Standards Board
Columbus Building
7 Westferry Circus
London
E14 4HD

28 March 2021

Dear Board Members,

Exposure Draft: Sale and Leaseback with Variable Payments

We support efforts by the Board to deal with diversity in how IFRS 16 is applied to sale and leaseback transactions with variable payments. However, we do not agree with the proposed amendment.

In our view the proposal will introduce a lack of comparability in financial statements, may at times fail to provide a faithful representation of lease liabilities and could lead to an accounting mismatch. In addition, we believe that the discount rate specified in IFRS 16 may not be appropriate when measuring lease liabilities with variable payments.

- **Lack of comparability:** The proposed approach will result in a difference between the accounting for leases with variable payments that originate as a result of sale and leaseback transactions, and those that do not. We do not think the circumstances by which leases came about justifies the different recognition and measurement of otherwise identical leases. Having two approaches for leases with variable payments will confuse investors. Perhaps investors will understand the difference at the time of the sale and leaseback, but the sale transaction will likely be forgotten in subsequent periods when there will still be a perplexing difference in accounting.

- **Not a faithful representation of lease liabilities:** The result of not remeasuring the lease liability when there are changes to the expected lease payments may result in the balance sheet obligation being overstated or understated. For example, for some companies Covid-19 may result in a significant reduction in variable lease payments which will reduce the burden of these leases. Measuring the liability based on the original expected payments rather than the potentially much lower revised amounts would not be a faithful representation of the current obligation. To appreciate the true position, investors would need to combine the reported lease liability with their own expectations of the lower future variable lease payment. This would be extremely challenging.

- **Accounting mismatch:** There may be a measurement mismatch between the right-of-use asset and lease liability for a lease with variable payments arising from a sale and leaseback transaction. If the expected lease payments decline significantly, then the cause of this reduction could also indicate that the right-of-asset is impaired. Recognising an impairment loss whilst not recognising the 'gain' due to the lower obligation would not faithfully depict performance.

- **Discount rate:** It is likely that the discount rate applied to measure leases with variable payments under the proposals would be the incremental borrowing rate, considering the difficulty of identifying all the components necessary to measure the rate implicit in the lease. However, the definition of the incremental borrowing rate, as currently written, may not be appropriate because it makes no mention of asset risk. For leases with variable payments the lessor is subject to asset and business risks during the term of the lease in addition to the usual credit risk. As a result, the rate charged would invariably be higher than for a lease with fixed payments. The lease discount rate should be determined taking this asset or business risk factor into account. If the IASB goes ahead with the amendment we suggest that this issue should be the subject of further research.

In our view all leases with variable lease payment should be accounted for in the same way, irrespective of how they came about.

Unless the board wishes to reopen the accounting for all leases with variable payments, our preferred approach would be to account for leases with variable payments arising in a sale and leaseback transaction in the same manner as currently specified in IFRS 16 for other leases with variable payments. Assuming no adjustment to defer a portion of any gain on sale, this accounting will result in the full difference between sale proceeds and carrying value being recognised in profit and loss. We do not think this is a problem and investors would be better served by recognising this full gain, and achieving consistency in accounting, than having the inconsistent treatment that would result from the ED.

Clearly the lessee retains control of the right-of-use asset that remains following a sale and leaseback and, arguably, a portion of the gain on sale is therefore unrealised. However, under the accounting for variable leases as currently specified in IFRS 16, this right-of-use asset is measured at zero which seems to justify the recognition of the full gain. Furthermore, in economic terms the lessee's interest in the asset is reduced, in comparison with a fixed lease, as a result of the risk transfer to the lessor. While considering risk and rewards may not be a conceptually valid argument under the IFRS Framework, it does provide further support for the logic of recognising the full gain.

Deferring a portion of the gain could be used to avoid recognition of an 'unrealised' gain. However, we think the resulting deferred credit would not meet the definition of a liability under the Framework and would not provide relevant information for investors. The resulting gain reported in subsequent periods would also not be relevant to the understanding of financial performance.

Consistent accounting could also be achieved by including all leases with variable payments in the balance sheet and amending the standard for leases with variable payments that do not arise from sale and leaseback transactions. If leases with variable payments were capitalised, we think they should be remeasured each period to ensure that the liability does not become out of date. The liability for leases with variable payments should also be disclosed separately given their very different economic characteristics compared with other leases.

While we think there is some merit in capitalising (and remeasuring) all leases with variable payments, there are also several counter arguments and challenges. This topic was discussed extensively during the development of IFRS 16, and we think that a change of this nature should only be considered following the post implementation review of the standard.

Our answers to specific questions are given below.

Yours,

Steve Cooper and Dennis Jullens

The Footnotes Analyst is a blog for investors and analysts on financial reporting and equity analysis that is written by Steve Cooper and Dennis Jullens. Steve Cooper is a former IASB Board Member. Dennis Jullens is an academic at Amsterdam Business School and a member of EFRAG Technical Expert Group. Both Steve and Dennis previously worked in investment banking, including as colleagues at UBS investment research.

Response to questions:

Question 1—Measurement of the right-of-use asset and lease liability arising in a sale and leaseback transaction (paragraphs 100(a)(i), 100A and 102B of the [Draft] amendment to IFRS 16)
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 disagree. Leases with variable payments arising from sale and leaseback transactions should be accounted for in the same manner as specified in IFRS 16 for other such leases. We do not think there should be a deferral of a portion of any resulting gain on sale.

If the IASB proceeds with the amendment we think that the liability in respect of leases with variable payments should be remeasured each period and should be disclosed separately from other leases. Furthermore, we believe that the definition of incremental borrowing rate should be amended to make clear that the rate applicable to leases with variable payments should take into account the implications of the asset and business risk transfers.

Question 2—Transition (paragraph C20E of the [Draft] amendment to IFRS 16)
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.