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29 March 2021

Hans Hoogervorst
Chair
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London
United Kingdom

Dear Mr Hoogervorst

ED/2020/4 Lease Liability in a Sale and Leaseback

Deloitte Touche Tohmatsu Limited is pleased to respond to the International Accounting Standards Board's ('the IASB's') exposure draft *Lease Liability in a Sale and Leaseback* ('the ED').

We recognise the efforts of the Board to address in a practical manner the subsequent measurement of the liability arising in a sale and leaseback transaction that includes variable payments. However, we do not support the proposals in the ED, largely for the reasons cited by Ms Flores in her alternative view.

We believe that sale and leaseback transactions is an area that will require further consideration as part of the post-implementation review of IFRS 16. As noted in our response to the IFRS Interpretations Committee in March 2020, we believe that the root cause of the issue addressed by the Committee may be the apparent conflict between IFRS 16 paragraphs BC262 and BC266. Paragraph BC262 conveys the notion that the right-of-use asset is a different asset from the underlying asset transferred to the buyer-lessor, hence supporting derecognition. However, in measuring the rights transferred and resulting gain or loss, paragraph BC266 views the right-of-use asset as a portion of the underlying asset retained. Until this conflict is resolved, it is likely that any solution to the "deferred gain problem" will also present conceptual flaws. In the case of the approach proposed in the ED, we are concerned that the method proposed results in recognition of a lease liability for the expected variable payments not based on an index or rate, which is inconsistent with the general requirements in IFRS 16.

Further, we are concerned that the proposals in the ED will be difficult to implement, as explained in the appendix to this letter.

Recognising that there is a need for a rapid solution to the issue and that any solution is likely to lack a conceptual basis until the root cause is addressed, we propose that a practical alternative would be to require that the "deferred gain" that results from the mechanical application of the existing requirements in IFRS 16:100 be recognised in profit or loss over the lease term on a straight-line basis (or another systematic basis) and presented as a reduction of the lease expense. We also suggest that no amendment

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be made at this time to specify the method that should be used by a seller-lessee to measure the proportion of the previous carrying amount of the lease asset that relates to the right of use retained.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

Appendix

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 do not support the proposals in the ED, largely for the reasons cited by Ms Flores in her alternative view.

As noted in our response to the IFRS Interpretations Committee in March 2020, we believe that the root cause of the issue originally addressed by the Committee may be the apparent conflict between IFRS 16:BC262 and BC266. IFRS 16:BC262 conveys the notion that the right-of-use asset is a different asset from the underlying asset transferred to the buyer-lessor, hence supporting derecognition. However, in measuring the rights transferred and resulting gain or loss, IFRS 16:BC266 views the right-of-use asset as a portion of the underlying asset retained. Until this conflict is resolved, it is likely that any solution to the "deferred gain problem" will also have conceptual flaws. In the case of the approach proposed in the ED, we are concerned that the method proposed results in recognition of a lease liability for the expected variable payments not based on an index or rate, which is inconsistent with the requirements otherwise applicable to such payments in IFRS 16. As noted in IFRS 16:BC169, there is no consistent view of whether variable lease payments linked to future performance or use of an asset meet the definition of a liability until performance or use occurs. Until this conceptual question is resolved, we believe the decision made when IFRS 16 was issued not to recognise a liability for such variable payments should be applied consistently to all leases, including sale and leaseback transactions.

We note that this inconsistency in accounting for variable lease payments not based on an index or rate will affect not only the statement of financial position, but also the statement of profit or loss where variable payments will be recognised at different times and in a different manner (through amortisation of the right-of-use asset in a sale and leaseback vs through lease expense otherwise) and the statement of cash flows where the cash flows representative of the expected variable payments will be presented as part of financing activities in a sale and leaseback vs as part of operating activities otherwise. As such, the proposals in the ED do not contribute to clear and transparent financial reporting.

Further, we are concerned that the proposals in the ED may be difficult to implement because they rely on an estimation of variable payments not based on an index or rate in order to determine the gain to be recognised on the sale, measure the lease liability (and the right-of-use asset) initially and remeasure the lease liability upon a change in the lease term or a lease modification. As also noted in IFRS 16:BC169, another reason that contributed to the decision that variable lease payments not based to an index or rate should not be recognised as a lease liability was the high level of measurement uncertainty associated with estimating these payments. Contrary to the explanation provided in BC19(a) of the ED, we do not believe that the fact that the seller-lessee owns and controls the underlying asset until the sale means that estimating variable payments is not highly judgemental. Indeed, the factors that contribute to the variability of payments are not necessarily entirely within the control of the seller-lessee but instead may be affected by economic factors, such as is the case when variable lease payments are based on sales. Further, contrary to what is implied in BC19(b) of the ED, a seller-lessee may not be required to estimate variable payments based on future performance or use in order to apply the existing requirements in IFRS 16:101. For example, a seller-lessee may be able to determine that the lease payments in a sale and leaseback transaction are at market rates by comparing the terms of the lease to those of other leases of comparable assets. Also, applying IFRS 16:102, the seller-lessee measures the off-market terms by comparing the fair value of the consideration for the sale and the fair value of the asset, if this is more readily determinable than the difference between the present value of the contractual payments and the present value of the expected lease payments (again, avoiding the need to estimate variable payments based on future performance or use).

We also note that the requirement to account differently for variable lease payments not based on an index or rate associated with a sale and leaseback will oblige a seller-lessee to track these transactions separately from other leases over potentially long periods since the different accounting requirements continue to apply following modifications to the lease and until the lease is terminated. This may represent a significant implementation issue.

The high measurement uncertainty associated with the estimation of variable lease payments based on performance or use of the asset is also a key reason why we believe that a seller-lessee should not be required to measure the right-of-use asset in IFRS 16:100(a)(i) based on a percentage that relies on this estimation. We believe that depending on facts and circumstances other methods, such as the proportion of the useful life of the asset covered by the lease term, may provide more reliable measurement of the proportion of the right of use retained. We also note that in some circumstances the proportion obtained by applying the formula proposed in the amendment to IFRS 16:100(a)(i) may exceed 100% which does not appear appropriate. For example, this may be the case if the contract for the leaseback includes a non-lease component and the seller-lessee applies the practical expedient in IFRS 16:15 to account for each lease component and any associated non-lease components as a single lease component. If the Board is concerned that a seller-lessee may conclude that the proportion of the right of use retained is nil simply because the leaseback is comprised entirely of variable lease payments not based on an index or rate, it may wish to provide additional guidance to assist a seller-lessee identify a relevant method.

Recognising that there is a need for a rapid solution to the issue and that any solution is likely to lack a conceptual basis, we propose that a practical alternative would be to require that the "deferred gain" that results from the mechanical application of the existing requirements in IFRS 16 be recognised in profit or loss over the lease term on a straight-line basis (or another systematic basis) and presented as a reduction of the lease expense. Applying this method to Example 25 proposed in the ED, and assuming consistently with this example that the proportion of the previous carrying amount of the lease asset that relates to the right of use retained is 24.98%, at the commencement date the seller-lessee would account for the transaction as follows

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Cash	CU1,800,000	
Right-of-use asset	CU249,801	
Building		CU1,000,000
Lease Liability, determined as the PV of the fixed lease payments discounted at 3.5%		CU383,780
Gain on rights transferred		CU600,159
Deferred gain, determined as the balancing amount		CU65,862

The "deferred gain" that results from the non-recognition of the expected variable payments based on future performance or use of the right-of-use asset would be recognised in profit or loss on a straight-line basis (or another systematic basis) over the lease term as a reduction of these variable payments.

If the Board was to decide to pursue the proposals in the ED, we suggest that the following points be addressed.

- Proposed paragraph 100A explains that the expected lease payments are comprised of specific payments at "market rates". Presumably the reference to "market rates" is meant to indicate that the payments used to measure the expected lease payments are adjusted for off-market terms that are accounted for as required by IFRS 16:101. We believe that this should be clarified.
- Further, we suggest that the term "expected lease payments" should be added as a defined term in Appendix A. This would help clarify that whenever the term is used in the new/amended paragraphs it refers to lease payments adjusted to reflect market rates.
- We note that it is proposed that an entity measures the potential off-market adjustment required by paragraph 101 on the basis of the more readily determinable of
  a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and
  b) the difference between the present value of the contractual payments for the lease and the present value of the expected lease payments

  It would be useful to provide guidance to explain if, and if so how, a seller-lessee allocates the off-market adjustment to the contractual payments in applying the requirements in proposed paragraphs 100A and 102B that both rely on payments adjusted to market rates. This guidance would be particularly useful when the adjustment is not determined by reference to the contractual payments (i.e. when it is instead measured based on a)).
- Also, whilst IFRS 16:101(b) explains that any above-market terms are accounted for as additional financing provided to the seller-lessee, it is only by referring to the proposed Illustrative Example 25 that one can understand clearly that the amount represents a separate financial liability from the lease liability recognised for the expected lease payments. We suggest that this should be clarified in the main body of the standard, along with the requirements applicable subsequently to this separate financial liability. As indicated above, this clarification should address how

contractual payments made by the lessee are allocated between the lease liability and this separate financial liability.

- Similarly, it may be useful to add a further example illustrating a sale and leaseback transaction with below-market terms. This would help in clarifying the application of the requirement to recognise the below-market terms as a prepayment of lease payments, including whether the prepayment should be presented as an asset separately from the right-of-use asset and how the requirements in IFRS 16:101a) interact with proposed paragraph 100A.
- Proposed paragraph 100A(a) appears to indicate that lease incentives are necessarily recognised as a reduction to fixed payments. It should be clarified how lease incentives are to be accounted for if the lease is comprised entirely of variable lease payments.
- It should be clarified whether the variable lease payments based on an index or rate described in proposed paragraph 100A(b) are determined using a spot rate or a forward rate. Whilst one would expect that for consistency with the general requirements in IFRS 16 a spot rate would be used, the reference to "expected lease payments" could be understood as requiring the use of a forward rate.
- Similarly, proposed paragraph 102(c) indicates that "[e]xcept for a change in the lease term or a lease modification (see paragraphs 40(a) and 45), the seller-lessee shall not remeasure the lease liability to reflect a change in future variable lease payments." This also brings ambiguity on whether variable lease payments based on an index or rate should be measured at initial recognition using a spot or forward rate. If these payments are not to be remeasured subsequently, use of a forward rate would be more relevant. However, this implies that variable lease payments based on an index or rate are determined in the case of sale and leaseback transactions inconsistently with the requirements otherwise applicable in IFRS 16. This does not appear to be addressed in the ED.
- Because of the high measurement uncertainty associated with the proposals in the ED, additional disclosure may be warranted. These may include the initial amount recognised in respect of variable lease payments not based on an index or rate as part of the lease liability and subsequent changes in expected lease payments.

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.

Putting aside the concerns we expressed in response to Question 1, we agree with the proposed transition provisions.

However, we note that the proposed paragraph C20E(a) should refer to the discount rate in paragraph 26 rather than in paragraph 37.

Further, we suggest that the Board clarifies how a seller-lessee that applies the alternative transition approach in paragraph C20E would account for amounts associated with the sale and leaseback transaction that it may have recognised separately from the right-of-use asset and the lease liability, for example as a result of applying IFRS 16:101 or the conclusion reached in the IFRS Interpretations Committee agenda decision of June 2020.