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AUTORITÉ DES NORMES COMPTABLES

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Exposure Draft ED|2020|4—Lease Liability in a Sale and Leaseback

Dear Hans,

I am writing to you on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned Exposure Draft (ED).

ANC understands that the IFRS Interpretations Committee (Committee) received a request describing a sale and leaseback transaction that includes variable lease payments linked to future performance or use of the underlying asset and asking how the seller-lessee accounts for that transaction. In an agenda decision published in June 2020[1], the Committee concluded that (i) the requirements in paragraph 100 of IFRS 16 *Leases* apply to this transaction and (ii) the seller-lessee recognises a liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate—in the Committee's view, this is because the initial measurement of the liability is a consequence of how the right-of-use asset is measured and the gain or loss on the sale and leaseback transaction determined applying paragraph 100(a) of IFRS 16. The Committee also recommended[2] the Board amend IFRS 16 to specify how the seller-lessee applies IFRS 16 subsequent measurement requirements to the lease liability arising in the sale and leaseback transaction.

Further to the Committee's recommendation, the Board proposes in the ED to amend IFRS 16 to (i) specify that the liability arising from the leaseback as described in the Committee's agenda decision is a lease liability to which IFRS 16 applies, (ii) add subsequent measurement requirements for *all* sale and leaseback transactions and (iii) to specify the method a seller-lessee uses in initially measuring the right-of-use asset and liability arising in such transactions. **Accordingly, the Board's proposals would affect the whole population of sale and leaseback transactions while the request that Committee had received identified matters to be solved only for *some* sale and leaseback transactions—ie those including variable lease payments linked to future performance or use of the underlying asset**. In other words, the Board's proposals could significantly modify the accounting for *all* sale and leaseback transactions and would have far-reaching consequences for lessees entering such transactions.

ANC thinks sale and leaseback transactions that include variable payments linked to future performance or use of the underlying asset highlight a conflict between two essential elements of IFRS 16, ie a contradiction between (i) the approach for sale and leaseback transactions underpinning paragraphs 100–102 of IFRS 16 and (ii) the measurement principle for a lease liability in paragraph 27 of IFRS 16 that excludes from the lease payments those that are linked to future performance or use. The ED shows that the Board decided to give precedence to the existing approach in paragraphs 100–102 of IFRS 16 for sale and leaseback transactions for the accounting of leaseback transactions that include variable payments linked to future performance or use of the underlying asset. **Consequently, if the Board's proposals were to be finalised, they would effectively result in a lessee recognising a liability for such variable payments**.

[1] June 2020 IFRIC Update
[2] March 2020 IFRIC Update

ANC observes that the accounting for variable payments linked to future performance or use of an underlying asset has been part of a long-standing debate that has cross-cutting implications. This matter is currently in the scope of a possible Board's research project on Variable and Contingent Consideration. ANC also observes that the Board concluded in paragraph 27 of IFRS 16 that a lessee excludes those payments from the measurement of a lease liability. **If finalised, the Board's proposals would result in a major 'reengineering' of the requirements in IFRS 16 by creating a dual model for measuring lease liabilities**—one model applying to lease liabilities and another model for lease liabilities arising from sale and leaseback transactions. Additionally, those proposals would also create differing measurement requirements for variable lease payments that depend on an index or a rate. Accordingly, ANC thinks those proposals go well beyond the remits of narrow-scope amendments to IFRS 16. The Board's proposals would also significantly increase the complexity of IFRS 16 and could result in application difficulties. For those reasons, **ANC recommends the Board not proceed with the proposed amendments.**

In ANC's view, the Board should proceed with an alternative way forward. Such an approach should only target sale and leaseback transactions that include variable payments linked to future performance or use of the underlying asset. It should also exclude variable lease payments that depend on an index or a rate. This would avoid unnecessary disruption for other sale and leaseback transactions and thus, unnecessary 'scope creeping'.

Applying that approach, the Board would first assess whether the leaseback requirements in paragraph 100 of IFRS 16 are suitable for sale and leaseback transactions that include variable payments linked to future performance or use of the underlying asset. In this respect, ANC agrees with the observations in paragraph AV2 of the alternative view and thinks the Board should assess the merits of the observations in paragraph AV3 of that same view.

If the Board were to conclude that the leaseback requirements in paragraph 100 of IFRS 16 should apply to those sale and leaseback transactions, ANC thinks the Board should consider a simpler approach than the one included in the ED. For example, the Board could consider whether an entity should recognise, at the commencement date of the lease, a 'deferred gain (or loss)' and then should recognise that gain (or loss) in profit or loss over the lease term. ANC does not overlook the possible conceptual limitations of this approach but outlines this would be a practical way of handling the matter, considering the existing application difficulties arising from IFRS 16. On balance, ANC would prefer such an approach to the Board's proposals that would bring excessive complexity to the requirements of IFRS 16. This approach, temporary by nature, could be reassessed at a later stage, for example when the Board reviews the overall approach for sale and leaseback transactions.

Appendix A to this letter includes ANC's detailed comments about the Board's proposals.

Should you need any further information, please do not hesitate to contact me.

Yours sincerely,

Patrick de Cambourg

Appendix A

This appendix explains why ANC disagrees with the approach underpinning the Board's proposals in the ED (part 1). This appendix also includes comments the Board may wish to consider should it decide to proceed with its proposals (part 2).

1. The overall approach the Board retained in the ED and a proposal for an alternative way forward

- ***Applying the existing approach in IFRS 16 for sale and leaseback transactions that include variable payments linked to future performance or use of the underlying asset is not a straightforward approach***

In paragraph BC266 of IFRS 16, the Board explained its approach to developing the requirements in paragraph 100 of IFRS 16 that apply to sale and leaseback transactions. In the Board's view, the seller-lessee that is party to in a sale and leaseback transaction, may have transferred legal ownership of the asset to the buyer-lessor, by entering into a lease of that same asset for a period of time. However, the seller-lessee has not, in fact, transferred all the rights embedded in legal ownership of the asset—it has transferred only its interest in the value of the asset at the end of the leaseback and retained its right to use the asset for the period of the lease. This right of use is not a newly-acquired right at the time of the sale and leaseback transaction because the seller-lessee obtained that right of use when it purchased the asset. Accordingly, the seller-lessee (i) does not remeasure the right of use retained—the right of use arising from the leaseback is measured as a proportion of the asset's previous carrying amount—and (ii) recognises in profit or loss only the amount of the gain (or loss) that relates to the rights transferred to the buyer-lessor. In the Board's view, not recognising the amount of the gain (or loss) that relates to the right retained by the seller-lessee appropriately reflects the economics of a sale and leaseback transaction.

In BC11 of the ED, the Board developed further its approach to sale and leaseback transactions and explained that *as a consequence* of the approach described in BC266 of IFRS 16, the initial measurement of the lease liability arising from the leaseback is derived from how the right-of-use is measured—and the gain or loss determined—applying paragraph 100(a) of IFRS 16. In other words, the requirements for sale and leaseback transactions imply that a lease liability is the 'balancing credit entry' when the sellor-lessee first accounts for the leaseback.

ANC first observes that, from a practical perspective, and consistent with the computations described in Examples 24 and 25 as amended in the ED, the sellor-lessee first determines the lease liability, measures the right of use, and then, derives the gain (or loss) on rights transferred—in other words, from a computational perspective, (i) the lease liability is the starting point for the accounting and (ii) the gain (or loss) on the rights transferred is the balancing credit journal entry. This perspective—which does not entirely tally with the Board's view in paragraph BC11 of the ED—explains why some stakeholders would focus on how to measure the lease liability and would intuitively apply the general measurement requirements for a lease liability in IFRS 16.

In the light of the existing requirements in IFRS 16, an entity would first account for a leaseback that does not include variable payments linked to future performance or use of the underlying asset in an identical manner regardless of whether the lease liability is the starting or ending point of the accounting—this is because, applying paragraph 26 of IFRS 16, all the payments the lessee is required to make are reflected in the measurement of the lease liability.

However, in ANC's view, there are valid questions about whether the Board's reading in paragraph BC11 of the ED still holds true when the leaseback includes variable payments linked to future performance or use of the underlying asset. In those circumstances, ANC thinks that an alternative view exists, ie that (i) such a transaction may trigger an important economic change and (ii) the sellor-lessee may not be required to include such variable payments in the measurement of any lease liability (or liability). Accordingly, when the leaseback only includes variable payments linked to future performance or use of the underlying asset, the sellor-lessee may measure a right-of-use at nil and recognise a gain computed as the difference between the sold asset's fair value and its carrying amount.

The Basis for Conclusions on the ED seems to ignore two closely-related matters that were subject to extensive discussions and could justify such an approach:

- the accounting for variable payments to be made for the purchase of an item of property, plant and equipment or an intangible asset that is not part of a business combination. The IFRS Interpretations Committee (Committee) extensively discussed this matter. ANC thinks this matter is similar, not to say identical in substance, to the recognition of a right of use for a leaseback that includes payments linked to future performance or use of the underlying asset. The March 2016 IFRIC Update explains that the

Committee was unable to reach a consensus on whether an entity (the purchaser) recognises a liability at the date of purchasing the asset for variable payments that depend on its future activity or, instead, recognises such a liability only when the related activity occurs. The Committee concluded that the Board should address the accounting for variable payments comprehensively.

- the accounting for variable payments linked to future performance or use of an underlying asset when the Board developed the measurement requirements in IFRS 16. Paragraphs BC168–BC169 of IFRS 16—surprisingly not mentioned in the Basis for Conclusions on the ED[3]—include the Board's observations for excluding such payments from the measurement of lease liabilities. Paragraph BC169 explains that some Board members thought that such lease payments meet the definition of a liability for the lessee but those members '…*were persuaded by the feedback received from stakeholders that the costs of including variable lease payments linked to future performance or use would outweigh the benefits, particularly because of the concerns expressed about the high level of measurement uncertainty that would result from including them and the high volume of leases held by some lessees*'. In contrast, some other Board members thought that such payments meet the definition of a liability for the lessee only when the performance or use occurs. Those Board members also thought that '…*variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future economic benefits to be derived from use of the asset*'. ANC thinks the Board's observations included in paragraphs BC168–BC169 equally apply when such variable payments are part of a leaseback.

- ***The case of sale and leaseback transactions including variable payments linked to future performance or use of the underlying asset highlights a conflict in IFRS 16 that the Board may have insufficiently thought through***

In reality, ANC thinks that sale and leaseback transactions that include variable payments linked to future performance or use highlight a conflict between two essential elements of IFRS 16, ie a contradiction between (i) the approach for sale and leaseback transactions underpinning paragraphs 100–102 of IFRS 16 and (ii) the measurement principle for a lease liability in paragraph 27 of IFRS 16 that excludes from the lease payments those that are linked to future performance or use. Accordingly, ANC concurs with the observations included in paragraph AV2 of the alternative view in the ED.

The proposals in the ED show that the Board has decided that, for sale and leaseback including payments linked to future performance or use, the approach for sale and leaseback transactions should take precedence over the measurement principle applying to any lease liability. In other words, the Board's proposals would result in an entity recognising a lease liability for variable lease payments linked to future performance or use. Having in mind the past discussions on the matter, ANC thinks that the Board's proposals, if finalised, would represent a major change in the existing principles of IFRS 16 and could create a potential confusion for users given the dual model proposed for the accounting of sale and lease back liabilities compared to ordinary lease liabilities. ANC also thinks that the public discussions which took place at the April and September 2020 Board's meetings, together with the lack of detailed discussion on this matter in the Basis for Conclusions on the ED, provide evidence that the Board may have understated the disruptive nature of its proposed amendments. Accordingly, ANC questions whether the proposed narrow-scope amendments are the appropriate way forward to address this issue.

ANC understands that the Board chose to give precedence to the approach for sale and leaseback transactions because such an approach would appropriately depict the economics of sale and leasebacks with variable payments. ANC appreciates the Board's intention in this respect—the Board could arguably reconsider the accounting for variable payments in specific circumstances if there were evidence that such a change would results in more useful information. However, ANC thinks that the Board may wish to give further thought to this matter. The Board has retained the existing analysis in paragraph BC266 of IFRS 16. This analysis is appropriate for leaseback transactions with fixed payments—the Board developed the requirements in paragraph 100 of IFRS 16 having in mind those transactions. However, ANC thinks the Board needs to demonstrate that this analysis still holds true for sale and leaseback transactions with variable payments—this is not so evident. In this respect, ANC notes that performance or usage-related payments may economically be structured to provide a sharing of future risks between the lessee and lessor—some Board members who approved the publication of IFRS 16 held this view as stated in paragraph BC169 of IFRS 16[4]. ANC also notes the alternative view included in paragraph AV4 of the ED explaining that a sale and leaseback with variable lease payments linked to future performance or use may be viewed as dissimilar, in substance, from a sale and leaseback with fixed payments. The fact that entities happen to enter sale and leaseback transactions to reduce exposure to the risks of owning the asset may be viewed as a corroborative argument for those viewing sale and leasebacks with variable payments as very specific transactions. Accordingly, ANC recommends the Board undertake public research and outreach to better

[3] Paragraph BC18 of the ED indirectly refers to paragraph BC169 of the ED by partially echoing the views of some Board members who approved the publication of IFRS 16.

[4] ANC notes that paragraphs AV5–AV8 of the Basis for Conclusions on the Exposure Draft ED/2010/9 Lease published in 2010 include Mr Stephen Cooper's alternative view in relation to contingent rentals. In its letter dated 24 December 2010, ANC agreed with this alternative view.

understand the economics of a sale and leaseback with variable payments linked to future performance or usage and thus, assess whether it could truly extend its approach in paragraph BC266 to such transactions.

- ***The Board's about-turn on the recognition of a lease liability for variable payments linked to future performance or use will add significant complexity to IFRS 16***

As explained above, the Board's proposals would result in the recognition of a lease liability for variable payments linked to future performance or use for some sale and leaseback transactions. This would contradict the overarching principle in paragraph 27 of IFRS 16 that excludes such payments from the lease payments and that applies to any lease unrelated to a sale and leaseback transaction—ie to most leases. This contradiction would result in a 'reengineering' of the requirements in IFRS 16 creating a dual model for measuring lease liabilities. ANC observes in this respect that the proposed paragraphs 100A, 102A and 102B replicate some general principles in IFRS 16 to make them work in the context of variable payments. In ANC's view, this may create additional complexity to an understanding of IFRS 16.

This complexity would be further increased by the differing measurement requirements that would also affect variable lease payments that depend on an index or a rate. Applying paragraph 27(b) of IFRS 16, a lessee measures a lease liability including variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date. Applying the Board's proposals, a lessee that is party to a sale and leaseback transaction would also measure the resulting lease liability by including such payments but would not retain a 'locked' index or rate—the lessee would be required to determine the expected changes in the index or rate on the measurement of the lease liability.

If the Board were to confirm its proposals, it would have to acknowledge that the estimation of variable payments linked to future performance or use would be subject to significant measurement uncertainty (and the estimation of variable lease payments that depend on an index or rate to a lesser extent[5]), in particular for arrangements with a long lease term. Such uncertainty could lead to increased volatility in profit or loss. The factors in paragraph BC19 of ED might, in some circumstances, mitigate this uncertainty in comparison to the one existing for a lease which is unrelated to a sale and leaseback transaction but are unlikely to reduce that uncertainty significantly. In ANC's view, the Board should, consistent with the observations in paragraph 2.22 of the *Conceptual Framework for Financial Reporting*, consider requiring an entity to disclose information about the estimate.

- ***The Board should contemplate retaining a simpler standard-setting approach***

ANC appreciates the Board's thoroughness in developing its proposals. However, ANC questions whether a very narrow-scope population of lease contracts—ie sale and leaseback with variable payments linked to future performance or use—really justifies such incremental complexity to IFRS 16. ANC also observes the 'scope-creeping' nature of this standard-setting project: the initial request that the Committee received described a sale and leaseback transaction including variable payments, calculated as a percentage of the seller-lessee's revenue generated using the underlying asset during the lease term. The Board's proposals would result in affecting all sale and leaseback transactions and capturing a wide spectrum of payments, including lease payments that depend on a rate or an index—this would create an additional source of divergence with the usual treatment of such leases under IFRS 16.

On balance, ANC thinks the Board might wish to reconsider the scope of the project and explore a pragmatic approach to solve the matter of sale and leaseback transactions with variable payments linked to future performance or use of the underlying item.

If the Board were to conclude that the gain the seller-lessee recognises when it transfers the control of the underlying asset should be measured applying the requirement in paragraph 100(a) of IFRS 16, it should not proceed with its proposal to require a recognition of a lease liability for variable payments linked to future performance or use. This is because such proposal would go well too far given the conceptual cross-cutting debate existing about the accounting for such payments—this debate permeated the Board's past deliberations on IFRS 16 and led the Board to add a project on Variable and Contingent Consideration to its research pipeline. Pending the completion of this project or of the review of the overall approach for sale and leaseback transactions, the Board should work on a temporary solution such as the recognition of a deferred gain (or loss) on the right that the seller-lessee has retained. ANC notes this approach could be similar to the requirement in paragraph 59 of IAS 17 *Leases*[6]. ANC also notes that the initial request to the Committee included a proposal along those lines[7]. ANC does not overlook the possible conceptual limitations of such a temporary approach but thinks it could be acceptable from a cost-benefit perspective. ANC notes that the implementation of IFRS 16 has already been

[5] ANC observes that the Board's observations in paragraphs BC165–BC166 remain valid in the context of this project.

[6] Paragraph 59 of IAS 17 stated: '*If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised over the lease term*'.

[7] See pages 22–23 of Agenda Paper 5 for the November 2019 Committee meeting.

challenging for many preparers who now expect the Board to retain, to the greatest extent possible, pragmatic approaches for solving issues arising from this Standard.

2. Comments on some Board's proposals

If the Board were to proceed with the approach as currently set out in the ED, ANC thinks that some clarifications or further improvements to the Board's proposals would be needed.

- ***Approach retained in the ED and determination of expected lease payments***

The Board proposes to amend paragraph 100(a) of IFRS 16 to require a seller-lessee to derive the measurement of the right-of-use asset arising from the leaseback by comparing the present value of the expected lease payments to the fair value of the asset sold. No other measurement method would be permitted. ANC observes that the ED would introduce a fundamental departure from the existing measurement requirements in IFRS 16 with regard to variable lease payments (including lease payments depending on an index or a rate). ANC also notes that the ED would result in a high degree of measurement uncertainty for leases including variable payments linked to future performance or use of the underlying item. Accordingly, ANC questions whether the Board should restrict the way a seller-lessee initially measures the right-of-use asset. Furthermore, in the absence of further application guidance in paragraph 100(a)(i) and of any limitation clause, ANC thinks that, in some circumstances, the present value of expected lease payments could be higher than the fair value of the underlying asset in its current state, in particular when the seller-lessee elects to apply the practical expedient in paragraph 15 of IFRS 16[8].

Furthermore, the Board proposes the insertion of paragraph 100A that makes a reference to 'lease term'. If the Board were to proceed with this proposal, IFRS 16 would clarify that the seller-lessee determines the leaseback term in accordance with the requirements in paragraphs 18–21 of IFRS 16 for determining a lease term. Applying paragraph 18(a) of IFRS 16, the lease term includes periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option. ANC notes that, in some circumstances, the existence of extension options in the leaseback raises questions with regard to whether the seller-lessee satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to account for a sale of the underlying asset. Applying the proposed paragraph 100A of IFRS 16 together with paragraph 18(a) of this IFRS Standard, the seller-lessee would exclude from the measurement of the lease liability lease payments from extension options whose exercise is probable but not reasonably certain. In those circumstances, ANC notes that the 'expected lease payments' the seller-lessee would retain for determining the lease liability would not necessarily portray its 'expectation' with the broad meaning of that word. Therefore, ANC recommends the Board clarify the interaction between paragraphs 100A and 18 of IFRS 16.

Additionally, ANC notes that the proposed amendments do not specify any methodology with regard to how the seller-lessee determines 'expected lease payments'. Should the seller-lessee refer to a single best estimate—which would enable to reduce the complexity of the proposed model for sale and leaseback—or it should it make a probability weighted assessment of all possible scenarios. Consequently, ANC recommends the Board clarify the methodology the seller-lessee should apply to estimate the expected lease payments.

As a final note, ANC observes that the seller-lessee would be required to initially measure the leaseback liability at the present value of the expected lease payments that are not paid at the commencement date, discounted using the rate specified in paragraph 26 of IFRS 16—ie the discount rate that applies to any lease liability. ANC thinks that the Board developed the requirement in paragraph 26 of IFRS 16 having in mind the specific features of the lease payments as currently specified in paragraph 27 of IFRS 16. Given the specific features of a liability that would arise from variable lease payments linked to future performance or use of the underlying asset—in particular, the source and magnitude of uncertainties that affect cash flows and that may be different from many other leases with fixed payments—ANC recommends the Board develop application guidance in this respect.

- ***Presentation of the leaseback liability in the seller-lessee's statement of financial position***

If the Board were to proceed with its proposal, a seller-lessee would include variable payments linked to future performance or use of the underlying asset in the measurement of the lease liability arising from the leaseback. This is a measurement approach that differs from the measurement of a lease liability as specified in paragraph 27 of IFRS 16. At the same time, ANC notes that a liability measured applying paragraph 27 of IFRS 16 and a liability measured applying paragraph 100A of the ED would both be labelled and presented in an entity's financial statements as 'lease labilities' whilst reflecting cash outflows reflect with differing levels of risk and uncertainty. Accordingly, ANC recommends the Board require an entity to present or disclose separately those lease liabilities in its financial statements or in the notes.

[8] Paragraph 15 of IFRS 16 states : '*As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease-component…*'.