Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
7 Westferry Circus
Canary Wharf
London
E14 4HD

26 March 2021

Dear Mr Hoogervorst

Invitation to Comment: Exposure Draft ED/2020/4 *Lease Liability in Sale and Leaseback (Proposed Amendment to IFRS 16)*

Following the UK's exit from the European Union, the Department for Business, Energy and Industrial Strategy (BEIS) has set up the UK Endorsement Board (UKEB) to fulfil statutory functions of influencing the development and subsequent adoption of International Accounting Standards for use in the UK. The UKEB secretariat has begun influencing activities in preparation for the delegation of those statutory functions to the UKEB. This letter forms part of those influencing activities and is intended to contribute to the International Accounting Standards Board's (IASB) due process. The views expressed by the UKEB secretariat in this letter are separate from, and will not necessarily affect the conclusions in, any endorsement and adoption assessment on new or amended International Accounting Standards to be provided to the Secretary of State or the UKEB, once powers have been delegated.

We welcome the opportunity to contribute to the debate on this topic and our main points on the consultation are outlined below. For detailed responses to the questions in the IASB's Exposure Draft (ED) please see appendix 1. Further stakeholder feedback on the proposals has been provided at appendix 2.

In principle, we support the proposals in the ED. By providing guidance on an area not covered by the existing standard they should reduce any diversity of practice, leading to consistency and comparability of financial statements. We understand that the information necessary to price and enter into the sale and leaseback transaction should be sufficient in most cases to meet the calculation requirements proposed in the amendment, so that improvement in consistency can be achieved at minimal incremental cost to preparers of financial statements.

However, specifically on variable lease payments, we note that the ED proposals create an inconsistency between the definition in IFRS 16, and that used in the ED. The likely benefit of the proposed approach in the ED is that any gain or loss on sale is captured in a way that reflects the underlying economic substance. However, it does that by expanding the definition of variable lease payments to capture such gains on transactions not currently within the scope of IFRS 16. Whilst we agree that accounting should reflect the economic substance of transactions we are concerned that the inconsistency between the IFRS 16 and the ED definitions will lead to inconsistency in financial reporting, as illustrated by the example we provide in paragraph A7 of appendix 1. We recommend that IASB resolve this discrepancy, either during the finalisation of the ED proposals or during the post implementation review of IFRS 16. In paragraphs A10–A11 of appendix 1 we explore different ways this could be achieved. Our preferred solution is to align the definition in the ED to the existing definition in IFRS 16, as explained in paragraph A10.

If you have any questions about this response please contact the project team at Contact@endorsement-board.uk

Yours sincerely

Pauline Wallace
Chair
UK Endorsement Board

Appendix 1 Questions on ED/2020/4 *Lease Liability in a Sale and Leaseback (Proposed Amendment to IFRS 16)*
Appendix 2 Additional Stakeholder Feedback

Appendix 1: Questions on ED/2020/4 *Lease Liability in a Sale and Leaseback (Proposed Amendment to IFRS 16)*

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.

A1 We support the proposed amendments. They provide clarity on measurement requirements for an area not addressed in the current standard. This will provide the benefit of reducing any potential diversity of practice in this area leading to increased consistency and comparability of financial statements.

A2 Sale and leaseback transactions can involve the sale of high value items of property, plant and equipment, potentially with long economic lives. So the benefits arising from the amendment are likely to be material to financial statements where such transactions occur.

Initial measurement of right of use asset

A3 We agree with the approach of requiring the seller 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. This approach is consistent with the existing requirements of IFRS 16, and the fair value approach is familiar to both preparers and users of financial statements.

A4 Though we have not gathered detailed evidence on this topic we understand the information required for such an approach to be reasonably available to preparers, without undue additional cost. While acknowledging some of the information (for example estimates of future variable lease payments) will be subjective or require estimation, the information prepared to price and enter into the sale and leaseback transaction should provide sufficient basis for calculating the proposed fair value of the asset and expected lease payments.

A5 We agree that the gain on sale should only be recognised on the portion of the underlying asset which is sold, as this reflects the economic substance of the transaction. However, we note that the lease liability solution proposed by IASB is not the only way to address this issue, and that this objective could equally be met by recording another form of liability or deferred gain. The use of such an approach for items with payments that fall outside the scope of IFRS16 variable Lease Payments would help avoid the difficulties arising from multiple definitions of lease payments discussed in paragraphs A6-A15 below.

Payments comprising expected lease payments

A6 We agree the amendment should specify the payments that comprise the expected lease payments for sale and leaseback transactions. This is particularly important given the alternative view described at AV1 and AV2 of the exposure draft, and the fact that the current definition of Lease Payments in IFRS 16 only allows for "variable lease payments that depend on an index or rate". Hence the proposed definition in paragraph 100A, along with the worked example at Example 25, are necessary to clarify that the amendment applies to variable Lease Payments beyond the scope of those defined in the original standard when subject to a sale and leaseback transaction.

A7 However, specifically on variable lease payments, we note that the ED proposals create an inconsistency between the definition in IFRS 16, and that used in the ED. The likely benefit of the proposed approach in the ED is that any gain or loss on sale is captured in a way that reflects the underlying economic substance. However, it does that by expanding the definition of variable lease payments to capture such gains on transactions not currently within the scope of IFRS 16. Whilst we agree that accounting should reflect the economic substance of transactions we are concerned that the inconsistency between the IFRS 16 and the ED definitions will lead to inconsistency in financial reporting.

A8 For example, when a lessee enters directly into a lease with variable payments based on a percentage of future revenues, these payments will fall outside the definition of Lease Payment for IFRS 16, and neither a Right of Use Asset nor Lease Liability will arise. However, if a seller-lessee enters into an otherwise identical lease via sale and leaseback the contract will meet the ED definition and create a Right of Use Asset and Lease Liability. This creates a lack of comparability in financial reporting between two entities who have entered into a lease contract with identical ongoing terms.

A9 We recommend IASB resolve this discrepancy, either during the finalisation of the ED proposals or during the post implementation review of IFRS 16. We can see two ways in which this could be achieved.

A10 Our preferred approach is that IASB use the definition currently in IFRS 16 for all purposes. The consequence of this is that those sale and leaseback transactions which have variable payments not based on a rate or index, would not give rise to a lease asset or liability. The correct gain on sale treatment could still be achieved by raising a non lease liability or deferred gain. This would result in lease contracts with the same characteristics being accounted for in the same way, irrespective of whether they were entered into directly or via sale and leaseback. This would resolve any concerns of inconsistency in financial reporting.

A11 IFRS 16 paragraph BC169 describes several reasons why variable lease payments linked to future performance or use were excluded from the scope of IFRS 16, including the high level of measurement uncertainty, costs outweighing the benefits of implementation, and the possibility that the definition of a liability is not met until such time as the future performance/use occurs. As a result, IFRS 16 does not create lease assets or liabilities in these circumstances. We think that these remain valid reasons for excluding such leases from the definition in the ED.

A12 This solution would reduce the impact for stakeholders, as it would only apply when there was a sale and leaseback featuring variable payments not based on a rate or index.

A13 An alternative approach to achieving consistency of treatment is to change the definition of Lease Payment in IFRS 16 to align with the new definition in the ED, by including variable lease payments which are not based on an index or rate. This would result in lease contracts with the same characteristics being accounted for in the same way, irrespective of whether they were entered into directly or via sale and leaseback. This would also resolve any concerns about inconsistency in financial reporting.

A14 This solution would also require the IASB to satisfactorily resolve the concerns raised at IFRS 16 paragraph BC169.

A15 However, this solution is not our preferred approach as it would have a larger impact on stakeholders. This will particularly be the case if retrospective application was required, as the wider definition would apply to all leases the entity had entered into involving variable payments not based on a rate or index, not just those related to sale and leaseback.

Subsequent measurement

A16 We agree with the proposed methodology for the subsequent measurement of the lease liability arising in the sale and leaseback transaction. The clarification will be helpful. If the lease liability is only remeasured in the event of a modification or change to the lease term, the regular recording of a gain or loss on the re-estimate of future events with significant measurement uncertainty is avoided.

Disclosure

A17 Given the judgmental nature of certain calculations required for the amendment we have considered whether further disclosure of key assumptions and estimates would be of assistance to users of financial statements. The use of judgements and estimates in accounting standards is not unique to this narrow scope amendment. IAS 1 *Presentation of Financial Statements* and IFRS 16 already require disclosure of information relating to assumptions about the future and estimation uncertainty. Specifically, IFRS 16 paragraph 59b already requires disclosure of additional information that helps users assess future cash outflows including those arising from variable lease payments. We do not feel further prescriptive disclosure related solely to this narrow scope amendment to be necessary nor proportionate. Hence, we agree with the ED not specifying further disclosure on this topic.

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.

A18 We would generally caution against retrospective application of narrow scope amendments. Whilst we acknowledge the benefit of the consistency that the restatement provides, the shorter consultation period associated with narrow scope amendments makes it difficult to gather sufficient evidence to fully understand the cost of historic application, and hence to form a robust view as to the cost/benefit of the proposal.

A19 In this instance, IFRS 16 was introduced in 2019, so the retrospective application would only cover a time period where records related to the transactions are likely to be readily available. In addition, entities generally undertake limited numbers of material sale and leaseback transactions. Given these factors we believe it is reasonable to assume that the benefit of retrospective application would outweigh the associated costs and would support the proposed retrospective application.

A20 We acknowledge that the proposals at paragraph C20E would help avoid the use of hindsight.

Appendix 2: Additional stakeholder feedback.

The suggested drafting of the amendment in the ED is overly complex and could lead to confusion. We recommend the wording is simplified and cross references to other parts of the standard are reduced. Our stakeholders had a number of suggestions to improve the drafting of the proposals, and having considered these we make the following recommendations to the IASB.

A21 We suggest the Board specify in paragraph 100(a)(i) either that the proportion of the previous carrying amount of the asset is limited to 100% of the previous carrying amount or that the comparison of fair values and lease payments relates to the asset status as when it was sold. In the absence of further guidance, the PV of expected lease payments may be higher than the FV of the underlying asset in some cases. For example:

a. if a lessee uses the practical expedient in paragraph 15 of IFRS 16 (ie to not separate non-lease components from lease components), and the lessee also uses that practical expedient for the purpose of measuring the liability in a sale and leaseback transaction, the proportion could exceed 100% (since the fair value of the underlying asset does not include the non-lease components) ; or
b. in a sale and leaseback transaction relating to an old building that requires significant renovation work, if the parties to the transaction agree that the buyer-lessor will make significant improvements to the asset and that the improvements are reimbursed by the seller-lessee as part of the lease payments in the leaseback, the PV of lease payments could be substantially above the fair value of the leased asset in its current condition.

A22 The proposed wording at 102(b) is not sufficiently clear to capture the adjustment required by paragraph 101 for transactions at off market rates. We recommend the wording is revised so that it refers to the difference between the present value of expected lease payments reflecting the contractual terms of the lease and the present value of the expected lease payments ***determined at market rates***.

A23 Stakeholders found the proposed illustrative examples helpful. We therefore recommend that Illustrative Example 24, showing a sale and leaseback transaction with off market terms, be expanded to demonstrate how paragraph 102B(d) would work in practice.

A24 We are concerned that the wording of paragraph 102B(d) when applied to in substance fixed payments will not work as intended. Should the in substance fixed lease payments requirements at IFRS16 B42 (a)(ii) apply this would result in the liability being remeasured and adjusted against the right of use asset, rather than being recognised in profit and loss as required by 102B(d) and paragraph 38 of IFRS16. We recommend the wording of 102B(d) is clarified to ensure the intent is clear and that any unintended contradiction in treatment is resolved.