25 February 2021

IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Sir/Madam

**RE: ED 2020/4 Lease Liability in a Sale and Leaseback**

We are responding to your invitation to comment on the exposure draft ED 2020/4 Lease Liability in a Sale and Leaseback (the 'ED') on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on the ED. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We support the need for an amendment to IFRS 16 to reduce the divergence of views on subsequent measurement that has resulted from the lack of guidance on sale and leaseback transactions with variable lease payments not dependent on an index or rate.

While we agree that the 'expected lease payments' model for variable lease payments proposed by the ED is one possible method to reflect the economics of sale and leaseback arrangements, we do not support the approach proposed in the ED at the present time.

We believe that the Board should consider any issues relating to variable lease payments holistically as part of the post implementation review of IFRS 16, or as part of any future project on variable and contingent consideration. Until that occurs, we believe that the Board should adopt a simplified approach for sale and leaseback transactions to achieve its objective of reducing diversity in practice. Introducing a new measurement approach for variable lease payments relating to a sale and leaseback now would prejudge the outcome of any such project, and is therefore considered premature.

*PricewaterhouseCoopers International Limited*
*1 Embankment Place*
*London WC2N 6RH*
*T: +44 (0) 20 7583 5000, F: +44 (0) 20 7822 4652*

The appendix to this letter sets out our suggested alternative approach but also provides detailed answers to the 'Questions for respondents' included in the ED should the Board decide to proceed with the proposals in the ED. We would be pleased to discuss our comments or to answer any questions that the IASB staff or the Board might have. Please do not hesitate to contact Henry Daubeney (henry.daubeney@pwc.com) or Jessica Taurae (jessica.taurae@pwc.com) regarding our response.

Yours Sincerely

Henry Daubeney
Partner, Global Chief Accountant and Head of Reporting
Mobile: 07841569635
Email: henry.daubeney@pwc.com

**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)**

We do not agree with the proposal for the measurement of the right-of-use asset and lease liability arising in a sale and leaseback transaction. The paragraphs below:

- explain why we do not support the approach proposed in the ED;
- set out our suggested alternative approach; and
- provide suggested improvements to the approach proposed in the ED, should the Board decide to proceed with those proposals.

**Why we do not support the approach proposed in the ED**

While we acknowledge that the Board's "expected lease payment model" may be one method of reflecting the economics of the transaction, the approach in the ED introduces a new model for variable lease payments limited to sale and leaseback transactions, that contradicts the definition of lease payments in IFRS 16 App A. This is because the proposed approach includes in the measurement of a lease liability, variable payments, not based on an index or a rate and as well as requiring entities to include forecasts for what expected rates or indices would be in the future. Although we agree there is a need for guidance on how to treat such variable payments for the purposes of gain recognition on a sale and leaseback, we do not think a new model for variable lease payments that applies only to sale and leaseback transactions should be introduced to achieve this outcome at this point in time. If the Board wishes to reconsider the issue of variable lease payments, we suggest that the Board wait until the post implementation review of IFRS 16, or any future project on variable and contingent consideration, to reconsider variable lease payments and contingent consideration holistically.

**Our suggested alternative approach**

We note the existing guidance in paragraphs 100-102 of IFRS 16, combined with the IFRS IC agenda decision 'Sale and Leaseback with Variable Payments (IFRS 16 Leases)—June 2020', provides sufficient basis to calculate the proportion of the gain/loss to be recognised on initial measurement of the gain/loss on the sale and leaseback transaction. Consequently, we do not propose any changes to the initial measurement.

However, we suggest an alternative unearned income approach for subsequent measurement that we believe could provide sufficient guidance to reduce diversity for variable lease payments in the near term, and would avoid introducing additional complexity or inconsistency with other requirements in IFRS 16 prior to a holistic review of variable lease payments and contingent consideration.

In our suggested approach, any portion of the amount relating to the right of use retained that is not included in the lease liability as currently required by IFRS 16 paragraph 27 should be considered as a deferral of income ('unearned income') rather than as part of the lease liability. An example of such income is income arising when the lease payments are entirely variable and not based on an index or rate as was in the original fact pattern for the IFRIC submission.

This unearned income should subsequently be amortised, on a basis which represents the realisation of the economic benefits to the seller-lessee. An appropriate basis would be a straight-line basis over the term of the leaseback unless another systematic basis is more representative of the pattern in which benefit is received by the seller-lessee. If the term of the leaseback is subsequently shortened, the recognition of unearned income should be adjusted proportionally - that is a proportionate amount of the unearned income should also be recognised as part of the reassessment of the lease liability, if any.

We believe that an unearned income model for subsequent measurement:

- would be consistent with the substance of the arrangement and that the amortisation of the unearned income would represent the flow of economic benefits to the entity, while still preserving the integrity of the existing IFRS 16 model for variable lease payments;
- would not introduce the same level of complexity as the Board's proposed model while still achieving the objective of recognising only the amount of any gain that relates to the rights transferred to the buyer-lessor;
- would allow the lease liability to continue to be recognised and measured in accordance with existing IFRS 16 guidance for other lease liabilities (para. 27 of IFRS 16), preventing the need for modifications to leasing systems to accommodate different measurement models;
- would be consistent with the Conceptual Framework, in that recording unearned income reflects that the increase in economic benefits to the entity at the time of the sale and leaseback transaction does not equal to full proceeds received. As the variable lease payments are not a lease liability applying current IFRS 16, another form of obligation should be recorded reflecting that this income will be earned as a result of the entity's continuing involvement in the transferred asset.

**Suggested improvements to the model proposed in the ED**

Although, as explained above, we do not support the model proposed in the ED, should the Board proceed with the proposals, we suggest the following improvements to reduce complexity and/or improve consistency:

- We note that in paragraph 100A, it is not clear whether the term "expected" denotes fair value based on probability weighted scenarios or a single best estimate. In our view, using a best estimate would reduce the complexity of the model and we recommend amending paragraph 100A to require a best estimate approach.

- In addition, we note that paragraph 100A relies on "lease term" which is defined in IFRS 16 and uses a "reasonably certain" threshold. If, for example, the seller-lessee expects, but is not reasonably certain, to extend the leaseback, in applying para 100A it would ignore the extension period, and therefore the "expected lease payments" would not actually reflect the lessee's expectation. Therefore this new complex model may result in outcomes that do not reflect expectations. We recommend the Board clarify how expectations are factored into lease term for the purposes of applying paragraph 100A.

- We suggest that 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 sold in the 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 as illustrated in the following example.

For example:

- ❏ 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
- ❏ 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.

- We note that in paragraph 102(b), it is unclear whether 'contractual payments' include variable payments based on an index or a rate and whether a comparison with 'expected payments' would be a like for like comparison. The Board should consider whether it would make more sense to retain the current words in IFRS 16 which are a comparison to 'payments for the lease at market rates' and clarify whether 'contractual payments' should include an estimation of future index or rate changes.

- We believe that paragraphs 102B(c) and (d) should be clarified to ensure that they do not lead to outcomes that are inconsistent with similar transactions. In particular, we suggest the Board clarify whether, in applying paragraph 102B(c), the in-substance fixed requirements in paragraph B42(a)(ii) are also intended to apply. Although paragraph 102B(c) states that an entity does not remeasure "future variable lease payments", payments that become in-substance fixed because the variability is resolved, are no longer "variable" future payments. We note that if paragraph B42(a)(ii) were to apply then the liability would be remeasured, and adjusted against the right-of-use asset, contradicting paragraph 102B(d) that requires recognition in profit or loss in accordance with paragraph 38. In addition, the timing of income statement recognition as described in paragraph 102B(d) appears to be inconsistent with that of other variable lease payments. For example, if the payment relating to year 1's revenue is expected and paid early in year 2, applying paragraph 102B(d),the difference between actual and expected payments is recognised in the period of the payments i.e. year 2 whereas paragraph 38(b) would require the payment to be included in the period in which the event that triggers the payment occurs which in this case is year 1.

- We also suggest the Board clarifies the concept of shortfalls in paragraph 102B(d) as we note that this notion of a 'due date' for payments is new and is unclear. We suggest that the Board replace the requirements in paragraph 102B(d) with the requirement that any difference between actual and expected cash flows should be recognised in the period in which the event or condition that triggers those payments occurs. This would align the timing of income recognition with that required by paragraph 38 for other variable lease payments, and would remove the need to introduce new concepts of when the payments are due or there is a shortfall, thereby reducing complexity.

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

We agree with the proposed transition guidance. We note that paragraph C20E(d) should refer to paragraph 26, rather than paragraph 37.