

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Lease Liability in a Sale and Leaseback Cover Note and Feedback Analysis

Objective

- 1 The objectives of the session are to:
 - (a) consider the feedback received in response to EFRAG's draft comment letter on the Exposure Draft ED/2020/4, *Lease Liability in a Sale and Leaseback*, issued by the IASB on 27 November 2020 (the 'ED'); and
 - (b) discuss and recommend to the EFRAG Board a final comment letter.

Background

- 2 On 27 November 2020, the IASB issued the ED to amend IFRS 16. The proposed amendment would specify the method a seller-lessee uses in initially measuring the right-of-use asset and liability arising in a sale and leaseback transaction and how the seller-lessee subsequently measures that liability.
- 3 At its 3 December webcast meeting, EFRAG TEG discussed the proposals in the ED and agreed to recommend to the EFRAG Board a draft comment letter prepared in response to the ED. The draft comment letter was approved by the EFRAG Board through written procedure and issued on 22 December 2020 with a comment period ending 22 February 2020 subsequently extended to 23 March 2021.
- 4 The published ED can be found [here](#).

EFRAG's initial assessment on the ED

- 5 EFRAG's draft comment letter contained three main assessments:
 - (a) EFRAG supported the proposals in the ED as they provided a practical fix on an area not currently addressed by the IFRS 16 and would result in a seller lessee recognising a gain only to the proportion of the rights it has transferred to the buyer-lessor.
 - (b) However, EFRAG considered that there is a broader issue to consider by the IASB because of a conflict in the principles in IFRS 16 between:
 - (i) 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 and
 - (ii) the principles underpinning paragraphs 100–102 for sale and leaseback transactions that a gain arising on the interest retained by the seller-lessee in a sale and leaseback transaction cannot be recognised. EFRAG therefore encouraged the IASB to reconsider the matter more broadly as part of the future Post Implementation Review of IFRS 16.

- (c) EFRAG also considered that there are challenges and complexity associated with the proposals in the ED, in particular regarding the level of judgement involved in estimating the future lease payments. To address the matter, EFRAG suggested that the IASB considers additional disclosures regarding the judgement applied in estimating the future payments.
- 6 EFRAG also included a question to constituents in its draft comment letter asking whether they agreed that the difference in the initial measurement of a lease liability arising from a leaseback and one arising from standalone leases is justified.

Comment letters received

- 7 EFRAG had received six comment letters by the time this cover note was uploaded. These letters are uploaded to EFRAG's website [here](#). A seventh letter was received in draft only and considered in the summary below. Any additional comment letters received before the EFRAG TEG meeting of 30 March 2021 will be uploaded and presented orally at the meeting.
- 8 The feedback received in response to EFRAG's draft comment letter on the Exposure Draft ED/2020/4, *Lease Liability in a Sale and Leaseback*, issued by the IASB on 27 November 2020 (the 'ED') is mixed. Those that do not support the proposals in the ED provided different reasons and suggestions.
- 9 Respondents generally agreed with the existence of a conflict in principles, the need to address it more holistically and the complexity of the proposed accounting. They diverged on whether the proposals in the ED were acceptable as a 'temporary fix' to address the issue at stake:
- (a) Two respondents supported EFRAG's assessment with no further comments.
 - (b) Another respondent while understanding EFRAG's assessment considered that the difference in the initial measurement of a lease liability arising from a leaseback and from a standalone lease was difficult to justify conceptually. They suggested to explore whether a presentation of the liability (corresponding to the proportion of the gain relating to the interests kept in the leaseback) as a 'deferred gain', rather than as lease liability, with amortisation over the lease term would not be preferable.
 - (c) Four respondents did not support the ED. However, they expressed different reasons for their lack of support.
 - (i) One respondent considered that the proposed accounting would be too complex and costly. This respondent assessed that the same measurement method existing in IFRS 16 should apply to all leases regardless of their origins and therefore the gain on a sale and leaseback with variable rents (not based on an index or rate) should be recognised in full.
 - (ii) One respondent considered that the recognition gain would depend on the economic factors and intention for which the sale and leaseback was entered into (financing, realising a capital gain, etc.) and there could be circumstances in which full or partial gain could be justified.
 - (iii) One respondent while supporting the intention of limiting the gain or loss to be recognised by a seller-lessee, considered that the proposed accounting was too complex for the intended objective. If the Amendments were to be maintained, this respondent suggested, as an alternative, to simply consider the deferral of the gain attributable to the retained interest in the right-of-use asset over the expected term of the leaseback.
 - (iv) One respondent considered that the IASB had stretched the scope of its ED too far by proposing amendments that would apply to all sales and

leaseback. In this respondent's view, the IASB should only focus on sale and leaseback transactions that include variable payments linked to future performance or use of the underlying asset, which was the original fact pattern submitted to the IFRS Interpretations Committee. By applying that approach, the IASB would first need to reassess whether the leaseback based on future performance or use would fall within the requirements in paragraph 100 of IFRS 16¹. If the IASB were to conclude that the leaseback requirements in paragraph 100 of IFRS 16 apply to such transactions, this respondent suggested to consider a simpler approach than the one included in the ED; for example, by recognising a deferred gain (amortised that gain in profit or loss over the lease term).

EFRAG Secretariat recommendation

- 10 The EFRAG Secretariat observes that respondents generally agreed with two of EFRAG's messages in the draft comment letter about:
 - (a) The necessity to address more holistically the conflict in principles in the context of the upcoming post-implementation review of IFRS 16; and
 - (b) The complexity of the proposed accounting.
- 11 However, respondents diverged on whether the proposals in the ED were acceptable as a 'temporary fix' to address the issue at stake with a majority assessing that this was not the case.
- 12 However, a majority of respondents considered that the gain ought to be limited to the transferred rights and several respondents (both proponents and opponents to the ED) suggested to consider a presentation of the liability as a non-lease liability or 'deferred gain' as a simpler temporary fix pending further analyses as this would avoid affecting the principles underpinning the definition of a lease liability in IFRS 16.
- 13 In the absence of consensus in the received feedback, the possible ways forward to be considered by EFRAG TEG could include:
 - (a) Option 1: keeping the views expressed in the draft comment letter
 - (b) Option 2: removing the explicit support for the proposals the ED while keeping the core messages on (a) the need to address holistically the conflict of principles and (b) the complexity of the proposed accounting. If the amendments are finalised suggest considering the merits of a presentation as deferred gain.
- 14 Option 2 has the merit to provide a temporary 'solution' to the question raised to the IFRS Interpretations Committee. The idea of deferring the gain and amortising it over the lease period is inspired from the accounting treatment that prevailed under IAS 17 (paragraph 59) for a sale and leaseback resulting in a finance lease.
- 15 However, that solution, as noted by some respondents, would not be conceptually solid as the notion of deferred gain 'would not be compliant with the definition of a liability under in the Conceptual Framework. Furthermore, using a temporary solution may increase the risk that entities employing it may have to subsequently restate their reporting.

¹ In this respect, without concluding on the matter, this respondent suggested that the IASB assesses the merits of the alternative view presented by one IASB member in paragraph AV2 and AV3 (i.e., whether an economic change in the situation in the seller-lessee's economic circumstances brings discontinuity that can justify full derecognition of the asset sold and recognition of any related gain in full).

Drafting suggestions

- 16 The mixed feedback received from a relatively low number of respondents, does not provide a clear indication to the EFRAG Secretariat regarding the drafting of the final comment letter. Therefore, the following section envisages two drafting options for the consideration of EFRAG TEG.

Option 1

- 17 EFRAG could, first, consider keeping the main messages as contained in the draft comment letter: See agenda paper 02-02.

Option 2

- 18 Considering the concerns expressed by a short majority of respondents, EFRAG could consider amending its response as follows (the text below is based the cover letter; the appendix would be revised similarly).

(Revised Text of the Cover Letter)

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2020/4 *Lease Liability in a Sale and Leaseback*, issued by the IASB on 27 November 2020 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

~~EFRAG observes that the proposed amendments would not result in changes to the existing measurement requirements in IFRS 16 applicable to all leases but rather explain how to apply the existing principles to leases arising in the context of sale and leaseback transactions that have variable payments not based on an index or rate.~~

~~EFRAG supports the proposals in the ED as they provide guidance on an area not currently addressed by the IFRS 16 and have the potential to reduce diversity in practice, while relying on principles that have been assessed to result in relevant information.~~

~~While being supportive of the proposals in the ED, EFRAG acknowledges considers that there may be a broader issue to consider by the IASB as there exists internal conflict between two main principles in IFRS 16:~~

- ~~• the exclusion of variable lease payments (not based on an index or rate) from the definition of lease payments, and~~
- ~~• the principle that when entering into a sale and leaseback transaction there should not be any gain on the interest retained by the seller-lessee.~~

~~EFRAG is concerned that the proposals are likely to lead to further inconsistency arising from the use of two different definitions of variable lease payments if they are not accompanied with clear analyses and explanation of the reason for the discrepancy.~~

~~EFRAG therefore encourages the IASB to reconsider the matter more broadly, possibly as part of the future Post Implementation Review of IFRS 16. This matter may also be considered as part of a possible IASB's research project on Variable and Contingent Consideration.~~

~~EFRAG can see that the benefit of the proposed approach in the \mp ED is that it would result in a seller lessee recognising a gain only to the proportion of the rights it has transferred to the buyer-lessor. EFRAG believes that recognising the full gain or loss on the sale would not have reflected the economics of a sale and leaseback transaction. Therefore, if the amendments resulting from the ED were to be finalised, EFRAG encourages the IASB to consider a simpler solution to achieve the same outcome by recognising 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 a leaseback.

EFRAG also note that there are complexities and operational challenges associated with the proposals in the ED, in particular regarding the level of judgement involved in estimating the future variable payments. Should the amendments resulting from the ED be finalised, and regardless of whether the liability is presented as a lease liability or a deferred gain, EFRAG recommends that the IASB consider additional disclosures regarding the judgement applied in estimating the future payments, such as how these estimates impact the measurement of the right-of-use assets and lease liability, and their sensitivity to the assumptions used.

Lastly, if the amendments were finalised EFRAG also supports the proposed transition requirements and in particular the retrospective application of the proposed amendments, unless in circumstances where such retrospective application cannot be done without the use of hindsight.

EFRAG's detailed comments and responses to the questions in the ED are set out in the Appendix.

Questions for EFRAG TEG

- 19 Does EFRAG TEG have questions on the summary of the feedback received from the consultation?
- 20 Which of the two proposed alternatives would EFRAG TEG support? Do you recommend additional changes to the two options proposed and, if so, which changes would you suggest?
- 21 If you do not support any of the two alternatives proposed, please indicate in which ways the final comment letter could be drafted.

In addition to this cover note, agenda paper 02-02 – *Final Comment Letter – Lease Liability in a Sale and Leaseback* has been provided for the session

Appendix – List of respondents

Respondent	Type	Country
NASB	Standard Setter	Norway
CNC	Standard Setter	Portugal
DASB	Standard Setter	Netherlands
ICAC	Standard Setter	Spain
SEAG	Organisation of preparers	Sweden
ASCG	Standard Setter	Germany