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Mr. Hans Hoogervorst
International Accounting Standards Board
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Ourref RD/288

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Dear Mr. Hoogervorst

Comment letter on ED/2020/4 *Lease Liability in a Sale and Leaseback*

We appreciate the opportunity to comment on the International Accounting Standards Board's (the Board) Exposure Draft *Lease Liability in a Sale and Leaseback – Proposed amendment to IFRS 16* (the ED). We have consulted with, and this letter represents the views of, the KPMG network.

We appreciate the Board's efforts to address the measurement problems identified by the IFRS Interpretations Committee (the Committee) in its discussion. We believe that the proposed approach of estimating expected variable payments is one possible way of addressing these problems. However, we question whether estimating expected variable payments should be prescribed as the only acceptable approach.

We note that this approach:

- represents a fundamental departure from the existing principles of IFRS 16 for variable lease payments;
- captures a wide spectrum of payment structures, including for example lease payments that depend on an index, which are commonly seen in sale and leaseback transactions; and
- would introduce a high degree of estimation uncertainty, particularly for long-term leases and/or in unstable markets.

We recommend that the Board be less prescriptive about the approach to be used to determine the lease payments and instead introduce appropriate safeguards to minimise structuring opportunities.



We have set out our detailed responses to the specific questions in the ED in the appendix to this letter.

Please contact Reinhard Dotzlaw at Reinhard.Dotzlaw@kpmgifrg.com or Kimber Bascom at kbascom@kpmg.com if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix: Responses to specific questions

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 agree with the conclusion of the Committee that the seller-lessee should measure the right-of-use asset arising in a sale and leaseback by applying paragraph 100 of IFRS 16 and recognise a gain only in relation to the rights transferred to the buyer-lessee. This means that even if all of the payments under the leaseback are variable, the seller-lessee will not measure the right-of-use asset at nil.

We agree that this conclusion creates uncertainty about how to measure the balances arising and appreciate the efforts of the Board to address this problem. We have the following comments about the ED's proposed solution.

Estimating expected variable payments

We believe that the proposed approach of estimating expected variable payments is one possible way of addressing the problem that was identified by the Committee. However, we question whether estimating expected variable payments should be prescribed as the only acceptable approach to measure the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee.

We note that this approach:

- represents a fundamental departure from the existing principles of IFRS 16 for variable lease payments;
- captures a wide spectrum of payment structures, including for example lease payments that depend on an index, which are commonly seen in sale and leaseback transactions; and
- would introduce a high degree of estimation uncertainty, particularly for long-term leases and/or in unstable markets.

We recommend that the Board be less prescriptive about the approach to be used to determine the lease payments and instead introduce appropriate safeguards to minimise structuring opportunities.

In some cases, the seller-lessee might determine its best estimate of the payments in the leaseback, as currently proposed. In other cases, the seller-lessee might use an alternative approach. For example, the seller-lessee might determine the initial amount of the right-of-use asset and corresponding liability by comparing the term of the leaseback to the economic life of the underlying asset. The seller-lessee would then determine the payments in the leaseback as the payments that would amortise that liability to nil over the lease term at the seller-lessee's incremental borrowing rate.

This would be subject to a safeguard that the profile of the payments in the leaseback as determined by the seller-lessee would reflect the profile of payments expected to arise under the terms of the leaseback. To take some common examples:

- In some cases, the annual payments will be variable but broadly constant over the lease term, for example, payments that depend on the output of a wind farm. In order to be representative of the expected payments, the payments determined by the seller-lessee would determine payments that were constant each year, i.e. an annuity payment.
- In some cases, the payments will be expected to increase over the lease term, for example payments that are subject to cumulative indexation each year. In order to be representative of the expected payments, the payments determined by the seller-lessee would also be subject to annual indexation.
- In some cases, the payments will be subject to an initial rent-free period. In order to be representative of the expected payments, the payments determined by the seller-lessee would also include the same rent-free period.

We appreciate that being less prescriptive might reduce comparability to some extent. However, the long lease terms seen in 'big ticket' sale and leaseback transactions mean that estimation uncertainty will often be high, such that comparability is subject to inherent limitations in any case.

Classification of liability as a lease liability

As noted in our comment letter on *Tentative agenda decision: Sale and Leaseback with Variable Payments*, the liability recognised by the seller-lessee appears to be fundamentally different to a lease liability for the following reasons:

- IFRS 16 contains specific guidance on the initial measurement of a lease liability, which should be applied to all lease liabilities; and
- that guidance excludes variable lease payments that do not depend on an index or rate from the measurement of the lease liability.

We are concerned that presenting lease liabilities arising under the currently effective version of IFRS 16 together with liabilities arising under the ED risks confusion and would not provide useful information. In particular, the liabilities are subject to different measurement risks and uncertainties.

We recommend that the Board require the liability arising in a sale and leaseback transaction to be classified as a separate liability (for instance as a "leaseback liability") and be disclosed separately from a lease liability or an IFRS 9 financial liability. We believe that this would help avoid the potential confusion that classifying the liability arising in a sale and leaseback transaction as a lease liability would cause for the users of the financial statements. A consequential amendment to IAS 7.17(e) should also be considered to include a reference to such a liability.

Expected lease payments at market rates

We recommend that the Board clarify the interaction between paragraph 100A of the ED that requires the expected lease payments to be measured at market rates and paragraphs 101 and 102 that require the seller-lessee to determine the off-market element.

For example, the ED proposes to amend paragraph 102(b) such that a seller-lessee would compare "the difference between the present value of the contractual payments for the lease and the present value of the expected lease payments". It is not clear that this is a correct comparison in this context. In a limiting case in which all payments in the leaseback are fixed, the contractual lease payments will equal the expected lease payments (i.e. both amounts will equal the fixed payments), so this comparison will not capture any off-market element.

Modification/ reassessment

We recommend that the Board clarify the accounting in cases in which application of the modification or reassessment guidance results in an extension to the lease term.

For example, suppose in a sale and leaseback transaction, the leaseback includes a non-cancellable period of 5 years and an enforceable renewal option for another 5 years. All payments for the leaseback are based on the revenue of the lessee, including those in the period covered by the renewal option. The seller-lessee initially determines the lease term to be 5 years. The lease term might subsequently become 10 years through a variety of mechanisms, e.g. a change in the non-cancellable period, a reassessment of whether the seller-lessee is reasonably certain to exercise the renewal option, or a lease modification.

If the seller-lessee subsequently determines that the lease term is 10 years, it is unclear what are the revised expected lease payments for years 6-10. BC29 states that the ED will result in the seller-lessee “subsequently measuring the lease liability on the same basis as its initial measurement”. Does this mean that the revised expected lease payments for years 6-10 are Nil, as no payments were initially included in the lease liability for these years? Or should the seller-lessee make an estimate of the expected lease payments for years 6-10 at the date the lease term is reassessed, to be consistent with the approach for years 1-5?

Put another way, does a lease that arises in a sale and leaseback transaction always retain the character of a leaseback, however much it is subsequently reassessed or modified?

Disclosures

If the Board were to proceed with classifying the liability arising in a sale and leaseback transaction as a lease liability, we recommend that the Board:

- specify additional disclosure requirements for a breakdown of lease liabilities showing separately amounts representing the obligations to make variable lease payments; and
- clarify how some of the IFRS 7 disclosure requirements would apply to such liability - e.g. sensitivity analysis disclosure as required under IFRS 7.40.

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.

We agree with the proposed transition requirements for entities currently applying IFRS Standards.

We note that there is currently no exemption in IFRS 1 directly applicable to sale and leaseback transactions entered into prior to the date of transition to IFRSs and the practice therefore is mixed. We recommend that the Board consider the need for consequential amendments to IFRS 1 in order to clarify the requirements for first-time adopters.