Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Sent electronically through the IASB Website (www.ifrs.org)

24 March 2021

Mr Hans Hoogervorst
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Hans,

IASB Exposure Draft ED/2020/4
Lease Liability in a Sale and Leaseback – Proposed amendment to IFRS 16

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing, and ethics for professional accountants, in Hong Kong. We are grateful for the opportunity to provide you with our comments on this Exposure Draft (ED).

The HKICPA appreciates the IASB's initiative to improve the accounting requirements for sale and leaseback transactions, and acknowledges the difficulties encountered by the IASB to improve these requirements without making significant changes to IFRS 16 *Leases* at this stage.

Nevertheless, we disagree with the proposals for the primary reasons that there is a lack in conceptual basis to account for a lease liability arising from a sale and leaseback transaction (leaseback liability) differently from a normal lease liability and we find the proposals complex to apply.

The HKICPA has carefully reviewed the ED and performed outreach with local stakeholders to broaden awareness of the proposals and collect feedback. We provide responses to the questions raised in this ED in the Appendix, with our primary concerns being as follows:

- There is lack of conceptual basis to account for a leaseback liability differently from a normal lease liability.
- It is debatable whether all variable lease payments meet the definition of a lease liability as indicated in paragraph BC168 of IFRS 16. The cost-benefits and other considerations detailed in paragraph BC169 of IFRS 16 are equally applicable in a sale and leaseback transaction.
- The proposed hybrid measurement model for the leaseback liability (see appendix for details) does not provide relevant information regarding the financial position, profit or loss, or the cash flows of the seller-lessee; nor does it provide a holistic view of the economics of the sale and leaseback transaction.
- The proposals would introduce significant practical challenges with regard to the estimation of future variable lease payments both from a preparer's and an auditor's perspective.
- Entities might have to incur significant costs to reconfigure their existing accounting systems to cater for the new measurement requirements for leaseback liabilities.

- The ED introduces a new undefined term “shortfalls” which raises further questions.
- Additional disclosures should be required for users to get a holistic view of the economics of the sale and leaseback transaction, particularly regarding the impact in profit or loss and the statement of cash flows if the proposals were to be pursued.

Instead of recognising a lease liability as per paragraph 100(a)(ii) of the ED, our stakeholders provided possible alternatives including recognising a full gain (similar to paragraphs AV1-AV4 of the ED) or a deferred gain on the date of the sale and leaseback transaction.

In terms of the deferred gain approach, the seller-lessee would (i) measure the right-of-use (RoU) asset and the gain/loss on the sale and leaseback transaction in accordance with the existing guidance in paragraph 100(a) of IFRS 16; (ii) measure the leaseback liability on the same basis as a normal lease liability; and (iii) recognise any resulting difference (net of selling price) as a deferred gain. The deferred gain would be amortised over the lease term to profit or loss on a straight line or other systematic basis.

We acknowledge there might be limited conceptual basis to these alternatives; however, they are simpler to apply than the proposals in the ED (which in our view also lack in conceptual basis) and they do not introduce significant changes to the existing principles in IFRS 16.

In addition to the above, we would suggest the IASB consider allowing other alternatives in determining the proportion of the asset retained depending on facts and circumstances and not restrict its determination to the present value of the expected future lease payments as a proportion of the fair value of the asset sold as proposed in paragraph 100(a)(i) of the ED.

Given the inherent conflict between the requirements for a sale and leaseback transaction and those for a normal lease in IFRS 16, we believe the IASB should revisit these issues holistically in the post-implementation review of IFRS 16.

If you have any questions regarding the matters raised in this letter, please contact me (ceciliakwei@hkicpa.org.hk) or Joni Kan, Associate Director of the Standard Setting Department (jonikan@hkicpa.org.hk).

Sincerely,

Cecilia Kwei

Cecilia Kwei
Director, Standard Setting Department

Work undertaken by HKICPA in forming its views:

The HKICPA:
(a) issued an Invitation to Comment on the ED on 11 December 2020 to our stakeholders;
(b) sought input from its Leases Advisory Panel comprising technical and industry experts and auditors from accounting firms; and
(c) developed its views through its Financial Reporting Standards Committee, having reflected on its stakeholders' feedback. The Committee comprises academics, preparer representatives from various industry sectors, investors, regulators, and technical and industry experts from small, medium and large accounting firms.

This submission outlines the HKICPA's views and summarises our stakeholders' comments on the ED/2020/4.

Detailed comments on IASB ED/2020/4

Question 1 – Measurement of the right-of-use asset and lease liability arising from a sale and leaseback transaction

Stakeholders' views

Lack of conceptual basis to account for a leaseback liability differently from a normal lease liability

1) Stakeholders are generally concerned that the IASB is proposing a fundamental change to how an entity accounts for a lease liability arising from a sale and leaseback transaction (leaseback liability). They find that paragraphs BC9-BC15 of the ED do not provide any conceptual basis for recognising a leaseback liability for expected variable lease payments. Instead, the IASB acknowledges at paragraph BC11 of the ED that the measurement of the leaseback liability is a function of how the right-of-use (RoU) asset and the gain/loss on the sale and leaseback transaction is initially measured, effectively relegating the leaseback liability to a 'residual' construct without conceptual basis.

2) The absence of a robust conceptual basis to rationalise the internal conflict between the measurement of a leaseback liability and a normal lease liability creates a risk of unintended consequences, and detracts from the quality and usefulness of the financial information produced.

3) Some stakeholders recommended the IASB should conduct a more fundamental and thorough analysis of what principles should prevail at the initial recognition of a sale and leaseback transaction, including fixed and/or variable lease payments.

4) Several practitioners shared that, as noted in paragraph BC168 of IFRS 16 *Leases*, there are divergent views as to whether variable lease payments linked to the future performance or use of an underlying asset meet the definition of a liability. Hence, it is questionable whether the proposals in paragraphs 100(a)(ii) and 100A(b) of the ED regarding a lease liability are conceptually sound.

5) These practitioners believed that the existing principles in paragraph 100(a) of IFRS 16 can be applied to a sale and leaseback transaction involving variable lease payments not based on an index or a rate by simply measuring the leaseback liability using the normal principles of IFRS 16 and recognising any difference as a deferred gain (instead of recognising it as a leaseback liability as per proposed paragraph

100(a)(ii) of the ED). The deferred gain would then be amortised to profit or loss over the leaseback term on a straight-line or other systematic basis.

6) A few practitioners are of the view that the gain/loss on the sale of the asset should be recognised in full at the date of the transaction as rationalised by arguments similar to those explained in paragraphs AV1-AV4 of the ED, and that the leaseback arrangement should be accounted for as a new normal lease arrangement.

7) On the other hand, a practitioner disagreed with the deferred gain and full gain concepts because in his view, since the RoU asset represents the portion of the full asset that has not been sold, no gain could arise on that portion as no sale has taken place for that portion of the asset. As such, there is no gain to be deferred in the first place. Hence, in his view, neither the full gain nor the deferred gain alternative is conceptually sound.

8) A few practitioners understood that the IASB would like to add additional guidance on how to determine the proportion of the asset retained given the current lack of guidance. However, they find the proposals requiring a determination of the present value of the expected future lease payments, including reference to the fair value of the asset sold, complex and potentially not practicable in certain circumstances. Additionally, other methods may be appropriate depending on facts and circumstances, e.g. to compare the leaseback period with the remaining useful life of the asset sold. Accordingly, they suggest that the IASB not restrict the method of determination to that proposed in the ED.

9) Several stakeholders also commented that the introduction of the ED's proposals would be disruptive to preparers. This is because substantial system changes may be necessary to cater for the proposed different measurement bases for sale and leaseback transactions and normal lease arrangements.

The proposed hybrid measurement model for the leaseback liability does not provide relevant information for the transaction

10) Some stakeholders considered that the prohibition of remeasuring the leaseback liability to reflect a change in future variable lease payments (except for a change in lease term or a lease modification) per paragraph 102B(c) of the ED indirectly introduces a "hybrid measurement model". Under such a hybrid measurement model, the initial estimates are recognised as a leaseback liability and any difference between those initial estimates (barring any modifications or changes in lease term) and actual payments is recognised in profit or loss as they arise. This hybrid measurement model was not contemplated when the IASB developed IFRS 16 and the current presentation and disclosure requirements do not provide meaningful information to users of financial statements (see paragraph 11).

11) As noted in paragraph BC3 of the ED, sale and leaseback transactions often involve high-value assets with a long economic life. If the IASB's observation in BC19 of the ED is indeed appropriate that an entity could reasonably estimate variable lease payments for sale and leaseback transactions, the majority of our stakeholders are of the view that the prohibition of remeasuring the leaseback liability for changes in expected variable lease payments (other than for a change in lease term or a lease modification) would significantly undermine the usefulness of financial information. This is because the estimates made on initial recognition would become less relevant given changes in facts and circumstances over a potentially long period of time. In particular:

- the balance sheet may no longer faithfully represent the current liquidity position of the seller-lessee;
- the profit and loss split between depreciation, interest expense and the gains or losses arising from the differences between the actual and expected lease payments may become meaningless as they are computed based on outdated expectations; and
- the statement of cash flows split between operating cash flows (difference between actual and expected lease payments) and financing cash flows (principal portions of the expected lease payments) may not fairly represent the entity's approach to cash management as it is based on outdated information.

12) Stakeholders understood and appreciated that the prohibition on revising estimates is made on cost and benefit grounds, and it was noted that paragraph BC30 of the ED states that IFRS 16 already includes various simplifications for variable lease payments (which was used to support the ED's proposal). However, those other simplifications would not result in the anomalies noted in paragraph 11 above. This is because under the existing model:

- no lease liability is recognised for variable lease payments that are not dependent on an index or a rate. Such lease payments are expensed as incurred; and
- the lease liability is remeasured when there is a change to the cash flows for variable lease payments that are dependent on an index or rate (paragraph 42(b) of IFRS 16). In other words, the lease liability is based on relatively current information, and apart from depreciation and interest expense, no gains or losses arising from the differences between the actual and expected lease payments are recognised in profit or loss.

13) Some stakeholders suggested the IASB should consider analogising to paragraph 42(b) of IFRS 16 to require a remeasurement of the leaseback liability in relation to variable lease payments that are dependent on an index or a rate when there is a change to future cash flows. However, to be consistent with the initial measurement of the leaseback liability as per paragraphs 100(a)(ii) and 100A of the ED, such subsequent remeasurement should include expected future changes in the index or rate, and not be based on the index or rate on the date of remeasurement. Such a suggestion is obviously subject to cost/benefits considerations.

14) Paragraph 102B(c) of the ED requires a seller-lessee to remeasure the leaseback liability as specified in paragraph 36(c) of IFRS 16, except in the circumstances described in paragraph 42(b) of IFRS 16. This means a remeasurement is required in the following circumstances:

- change in lease term;
- change in assessment of whether to exercise a purchase option (not applicable here as the presence of a purchase option would have precluded the transaction to qualify as a sale in the first place in terms of paragraph B66 of IFRS 15 *Revenue from Contracts with Customers*);
- change in expected residual value guarantee (RVG);
- change in in-substance fixed lease payments; or
- lease modifications.

However, the second and the last sentences of paragraph 102B(c) of the ED refers to a change in lease term and lease modification only. We recommend that the IASB include references to changes in RVG and in-substance fixed lease payments in these sentences to ensure consistent application.

15) With regard to applying paragraph 102B(c) of the ED in remeasuring the leaseback liability, stakeholders had split views on whether the corresponding adjustment should be recognised in profit or loss or be recognised against the RoU asset. Some stakeholders supported recognition in profit or loss given the RoU asset arising from a leaseback transaction is initially measured differently from that of a normal lease arrangement. Hence, the principles in paragraph 39 of IFRS 16 do not apply. In contrast, other stakeholders considered the impact should adjust the RoU asset similar to the normal principle for remeasurement as stated in paragraph 39 of IFRS 16, to avoid structuring opportunities for gains in future periods.

16) A majority of our stakeholders suggested that the IASB reconsider the drafting of paragraph 102B(c) of the ED as they find the current wording difficult to understand.

Measurement uncertainty of variable lease payments

17) Stakeholders generally considered that estimating performance-based variable lease payments and future changes in indices or rates is subject to the same high level of measurement uncertainty for a sale and leaseback transaction as that for a normal lease arrangement.

18) Many stakeholders considered that the IASB's concerns regarding variable lease payments when developing IFRS 16 (as noted in paragraphs BC163-169 of IFRS 16) remain valid with regard to a sale and leaseback transaction. Future changes in indices and rates are outside the control of an entity, and estimation does not necessarily become more certain under a sale and leaseback transaction. As for performance-based variable lease payments, having owned the asset before does not necessarily make the estimation of future performance more reliable than in a normal lease arrangement, as one would expect the entity to have carried out proper financial due diligence before entering into a normal lease arrangement subject to performance-based variable lease payments. These stakeholders questioned whether the observation in paragraph BC19(a) of the ED that 'the Board expects that seller-lessees would be able to reasonably estimate the expected lease payments' is justified.

A new undefined term "shortfalls"

19) Paragraph 102B(d) of the ED states "If there are shortfalls in the actual payments made (i.e. payments made are less than the payments due) or recoveries of shortfalls…". The term "shortfalls" is not defined in the proposal, nor is it an existing concept in IFRS 16. The reference to the lessee's paying less than what is due implies there has been a credit loss event, and the proposals require the leaseback liability to be reduced with a corresponding entry to profit or loss; however, it is not clear whether the seller-lessee has been legally released from the obligation to pay.

20) Some stakeholders recommended the IASB revisit the wording of paragraph 102B(d) of the ED and clarify what is meant by "shortfalls", with examples illustrating the journal entries to ensure consistent application.

Additional disclosure requirements

21) The current disclosure requirements in paragraphs 53(a), (b) and (e) of IFRS 16 do not cater for variable lease payments that are recognised as lease liabilities. As such, the value of information provided by these paragraphs, if unchanged, would be diluted as users would not be able to ascertain what the full variable lease payments were during the year, which is split into depreciation, interest expense and other variable gains/losses under the proposals.

22) Paragraph 59(b)(i) of IFRS 16 is limited to future cash ***outflows*** not included in the lease liability and does not require disclosure of future cash ***savings*** that could arise under the proposals (e.g. the actual performance-based lease payments are less than the initial expected performance-based lease payments).

23) Overall, stakeholders believe that the IASB should consider requiring separate disclosures for sale and leaseback transactions and normal lease transactions on both initial recognition and subsequent measurement given the inherent differences in accounting between these transactions under the proposals.

Other drafting issues

24) Stakeholders have asked the IASB to clarify the following drafting issues:

- The first sentence of paragraph 102B(d) of the ED – it is not clear why the IASB excludes above-market terms only and not below-market terms as well.
- Paragraph 102(b) of the ED – suggest rewording as 'the difference between the present value of the contractual expected lease payments and the present value of the payments for the lease at market rates'. This is because the key is to compare contractual rates (e.g. 2% of turnover) with market rates (e.g. 5% of turnover) in order to work out the off-market portion. However, the current wording refers to 'contractual payments' and 'expected lease payments' without any reference to market rates which is the same thing (both at 2% of turnover using the above numbers).

HKICPA analysis and recommendation

25) The HKICPA shares similar concerns as expressed by our stakeholders on the proposed amendments in the ED. There is a lack of conceptual basis for introducing a different measurement model for the leaseback liability compared to a normal lease liability. Additionally, the proposed hybrid measurement model for a leaseback liability, with no remeasurement thereof when there is a change in the expected future variable lease payments (barring a change in lease term or a lease modification), would not provide relevant information to users with regard to the financial position, financial performance or cash flows of the seller-lessee in relation to the sale and leaseback transaction. Moreover, the proposals are complex and preparers' existing accounting systems may not be able to cater for the proposed requirements. All these factors will increase costs and complexity for entities when applying the Standard.

26) We acknowledge that the IASB explains in paragraph BC19 of the ED that seller-lessees would be able to reasonably estimate the expected lease payments because seller-lessees are in a different position from normal lessees. However, stakeholders generally believe that estimating future variable lease payments for sale and leaseback transactions (performance-based or based on index/rate) are subject to the same high level of estimation uncertainty as with normal lease arrangements

because the lease payments depend on factors that are outside the seller-lessee's control.

27) In light of the above, we recommend that the IASB conduct a thorough analysis of what principles should prevail at the initial recognition of a sale and leaseback transaction involving variable lease payments.

28) In order to provide a short-term solution that is simple to apply with minimal changes to IFRS 16, we suggest that the IASB consider the alternatives suggested by our stakeholders; namely recognising a full gain or a deferred gain on the date of the sale and leaseback transaction. Though these alternatives may not be conceptually ideal (noting that in our view there is a similar lack of conceptual basis for the proposals in the ED), they are simple to apply without significant amendments to the existing Standard.

29) If the Board decides to go ahead with the proposals, we would recommend the Board:

- Consider alternatives to determining the proportion of the asset retained under paragraph 100(a)(i) of the ED and not limit the determination to the present value of the expected lease payments as a proportion of the fair value of the asset sold;
- Consider analogising to paragraph 42(b) of IFRS 16 to require a remeasurement of the leaseback liability in relation to index-based variable lease payments when there is a change to the cash flows. However, to be consistent with the leaseback liability's initial measurement, such a remeasurement should include expected future changes in the index/rate, and not be based on the index/rate on the date of remeasurement. A similar remeasurement should be required in the circumstances described in paragraph B42(a)(ii) of IFRS 16 in relation to in-substance fixed lease payments;
- Clarify the drafting of paragraphs 102(b), 102B(c) and (d) of the ED to address our stakeholders' concerns;
- Introduce additional disclosure requirements to address sale and leaseback transactions involving variable lease payments regardless of whether they depend on an index or a rate; and
- Re-assess the sale and leaseback accounting in the post-implementation review of IFRS 16.

<u>Question 2 – Transition</u>

Stakeholders' views

30) Stakeholders generally agreed with and did not have major comments on the proposed transition requirements in paragraph C20E of the ED.

HKICPA analysis and recommendation

31) If the IASB decides to go ahead with the proposals, we agree with the proposed transition requirements, particularly the requirements in paragraph C20E of the ED to avoid the use of hindsight and to ensure consistent application as explained in paragraph BC34 of the ED.