ASC
ACCOUNTING STANDARDS COUNCIL
SINGAPORE

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Mr Hans Hoogervorst
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(By online submission)

Dear Hans

RESPONSE TO EXPOSURE DRAFT ON LEASE LIABILITY IN A SALE AND LEASEBACK (PROPOSED AMENDMENT TO IFRS 16)

The Singapore Accounting Standards Council appreciates the opportunity to comment on the Exposure Draft on *Lease Liability in a Sale and Leaseback* (Proposed amendment to IFRS 16) (the ED) issued by the International Accounting Standards Board (the IASB) in November 2020.

We are largely supportive of the IASB's proposed amendments to complement the existing requirements for sale and leaseback transactions in IFRS 16 *Leases*, by specifying the method a seller-lessee uses in initially measuring the right-of-use asset and liability arising in a sale and leaseback transaction, and the subsequent measurement requirements for that liability. The proposed amendments would address practice diversity, without changing the principles underlying the requirements for sale and leaseback transactions.

Our specific comments on the ED are as follows:

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

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(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 are largely supportive of the proposed amendments.

<u>Lease liability within the scope of IFRS 16</u>

We agree with the IASB's rationale for concluding that the liability arising from the leaseback in a sale and leaseback transaction is a lease liability to which IFRS 16 applies.

<u>Measurement requirements for lease liability</u>

(A) Whether variable lease payments should be included in measurement of lease liability

We agree with the IASB's conclusion that it would be inappropriate to reconsider the requirements for sale and leaseback transactions in IFRS 16 more holistically in advance of the post-implementation review of the Standard.

Applying the sale and leaseback requirements, a key principle is that the recognition by the seller-lessee of a full gain or loss on the sale of the asset would not reflect the economics of the sale and leaseback transaction. The seller-lessee controls the asset until the transaction date, and thereafter, continues to control the use of the asset during the lease term. For the transaction to contain a lease, the seller-lessee must have the right to direct the use of the asset, and *to obtain substantially all of the economic benefits from such use*. The seller-lessee is not prevented from having the right as described in italics, even if the leaseback includes variable lease payments that depend on future usage or performance that effectively transfers part of the seller-lessee's exposure to a change in the value of the asset during the lease term to the buyer-lessor. Therefore, the seller-lessee should not recognise a gain or loss that relates to the right to control the use of the asset during the lease term, regardless of whether the leaseback includes variable lease payments that do not meet the definition of lease payments.

As a consequence, the seller-lessee would have to include variable lease payments in determining the proportion of the previous carrying amount of the asset that relates to the right of use retained, and therefore, the initial measurement of the lease liability. The approach would result in an initial measurement of the lease liability that reflects the value of the right of use retained (in the absence of off-market terms), and therefore, avoid recognising the portion of the gain or loss that relates to the right of use retained.

Similarly, the seller-lessee would have to include variable lease payments in the subsequent measurement of the lease liability. The inclusion of all payments, regardless of whether they

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meet the definition of lease payments, would avoid recognising additional gain or loss associated with the sale and leaseback transaction when no underlying transaction or event has occurred to give rise to such a gain or loss. We consider it relatively less important to align with the subsequent measurement requirements for lease liabilities that are unrelated to sale and leaseback transactions, given the different requirements for initial recognition between a lease in a sale and leaseback transaction and other leases.

(B) Method for inclusion of variable lease payments

We agree with prescribing a method for determining the initial measurement of the right-of-use asset and lease liability arising from a leaseback, including how variable lease payments are reflected in the measurement. It would prevent the use of methods that could add complexity to the subsequent measurement of the lease liability, or result in the recognition of additional gain or loss solely because of a change in the measurement basis subsequent to initial measurement. Moreover, a consistent use of the prescribed method would improve comparability across seller-lessees, and within a seller-lessee that has sale and leaseback transactions that give rise to leases with different characteristics or in different circumstances.

In determining the prescribed method, we support an approach that most aligns with the measurement requirements for other lease liabilities, apart from those relating to variable lease payments that do not meet the definition of lease payments.

Therefore, we are supportive of the prescribed method being the present value of expected lease payments, discounted using the rate specified in paragraph 26 of IFRS 16 (subject to consequential amendment as described below). The proposed approach would not prevent the seller-lessee from applying similar principles for subsequent measurement (save for variable lease payments that do not meet the definition of lease payments) between lease liabilities arising from a leaseback and other lease liabilities. In contrast, the use of any other approaches would require the seller-lessee to impute either the payments in the lease or the discount rate, or both, if the seller-lessee were to avoid recognising additional gain or loss solely because of a change in the measurement basis. Those other approaches may have implications as described in paragraph BC26 of the Basis for Conclusions on the ED. For those reasons, the proposed approach would be preferable to the alternative imputed lease payment and imputed discount rate approaches.

We are inclined to agree with the IASB's expectation that a seller-lessee would be able to reasonably estimate the expected lease payments. In particular, a seller-lessee controls the underlying asset until the sale and leaseback transaction, and therefore, should have access to information necessary to reasonably estimate the expected lease payments.

Nevertheless, the IASB should consider clarifying that, in applying paragraph 26 of IFRS 16 to the expected lease payments, the reference to 'lease payments' in the definition of 'interest rate implicit in the lease' should be the expected lease payments instead. Otherwise, there would be a mismatch between the payments included in the estimated cash flows, and the payments used to determine the rate that is applied to discount those cash flows.

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(C) Components of expected lease payments

We agree with the components of expected lease payments as proposed in the ED. The components are consistent with the definition of lease payments, except for: (i) the inclusion of variable lease payments that do not depend on an index or a rate, which is consistent with the principle underlying the sale and leaseback requirements; and (ii) the exclusion of the exercise price of a purchase option, which is not applicable to sale and leaseback transactions.

We further agree that expected lease payments should reflect payments at market terms, and therefore, with the consequential amendment to paragraph 102 of IFRS 16. The outcome is that the initial measurement of the lease liability would reflect the value of the right of use retained, while any off-market term would be accounted for as either a prepayment of lease payments or additional financing provided by the buyer-lessor.

(D) Specific subsequent measurement requirements

We are supportive of the specific proposed subsequent measurement requirements, for cost-benefit reasons.

In particular, a seller-lessee would not remeasure the lease liability arising from a leaseback for a change in variable lease payments, including those that depend on an index or a rate, unless there is a change in the lease term or a lease modification. It contrasts with the existing requirement to remeasure other lease liabilities for a change in variable lease payments that depend on an index or a rate.

As mentioned earlier, we consider it relatively less important to align with the subsequent measurement requirements for lease liabilities that are unrelated to sale and leaseback transactions. The initial measurement of a lease liability arising from a leaseback does not differentiate between variable lease payments that depend on an index or a rate, and those that do not. The proposed requirements would result in a seller-lessee accounting for variable lease payments similarly regardless of whether they depend on an index or a rate, both on initial recognition and subsequently. Importantly, a requirement to remeasure a lease liability arising from a leaseback to reflect changes in all of such variable lease payments may incur costs that do not justify the overall benefits. This is because IFRS 16 already includes measurement exceptions for other lease liabilities in relation to variable lease payments that do not depend on an index or a rate.

It follows that the seller-lessee would recognise any difference between the actual payments and the expected lease payments in profit or loss (or the carrying amount of another asset, as appropriate) in the period in which the event or condition that triggers those payments occurs. It would be consistent with the accounting treatment for variable lease payments that are not included in the remeasurement of lease liabilities that are unrelated to sale and leaseback transactions.

That said, we think that there is a need to clarify the term, and the proposed accounting for, ‘shortfalls’ and ‘recoveries of shortfalls’ in the actual payments made for the lease. The ED describes shortfalls as a situation in which the payments made are less than the payments due.

If these terms are intended to refer to payment in arrears or settlement of such payment, it is not intuitive why a shortfall or a recovery should be recognised in profit or loss (or the carrying amount of another asset, as appropriate), other than to achieve an offset so that the net amount recognised in profit or loss (or the carrying amount of another asset, as appropriate) is the difference between the payments due and the expected lease payments. We suggest that the IASB considers drafting refinements to clarify its intention.

For a change in the lease term or a lease modification, we are supportive of remeasuring a lease liability arising from a leaseback to reflect the revised payments, including variable lease payments regardless of whether they depend on an index or a rate, over the remaining lease term. IFRS 16 already requires remeasurement of lease liabilities that are unrelated to sale and leaseback transactions to reflect revised lease payments discounted using a revised discount rate in such cases. Any remeasurement should be based on the revised expected lease payments (instead of the revised lease payments as defined in IFRS 16) to avoid recognising additional gain or loss associated with the sale and leaseback transaction. If a seller-lessee had been able to reasonably estimate the expected lease payments at initial recognition, the seller-lessee should be able to reasonably estimate the revised expected lease payments when there is a change in the lease term or a lease modification.

Measurement requirements for right-of-use asset

(A) Components of cost

We think that applying the prescribed method may have unintended consequences on the initial measurement of the right-of-use asset.

The previous carrying amount of the asset transferred in a sale and leaseback transaction may include estimated costs of dismantling, removing or restoring the asset. Applying the prescribed method, those costs would be allocated proportionately between the right of use retained and the rights transferred to the buyer-lessor.

Instead, the IASB could consider whether those costs should be attributed solely to either the leaseback or the rights transferred, depending on which party has the primary responsibility for those costs. If the seller-lessee has the primary responsibility for those costs (for example, because it is obligated to restore the asset at end of the leaseback), the seller-lessee cannot avoid those costs because it has the leaseback (as opposed to the seller-lessee cannot avoid those costs even if it does not have the leaseback). An inclusion of those costs in the measurement of the right-of-use asset would be consistent with the cost model. Conversely, if the buyer-lessor has the primary responsibility for those costs, it would be appropriate for the seller-lessee to attribute those costs to the rights transferred in determining the amount of profit or loss recognised. At the date of the sale and leaseback transaction, there is a difference between the provision for restoration costs derecognised and those costs that remain in the carrying amount of the asset. That difference represents restoration costs previously recognised in profit or loss that would no longer be incurred as a result of the sale and leaseback transaction.

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In addition, the seller-lessee may incur initial direct costs on the leaseback. A strict application of the proposed amendments would require the seller-lessee to exclude those costs from the initial measurement of the right-of-use asset, and therefore, recognise them in profit or loss as they are incurred. We believe that the outcome would not reflect the IASB's intention.

Therefore, we suggest that the IASB develops the necessary clarifications accordingly.

(B) Subsequent measurement

We agree with the proposed subsequent measurement requirements, which are fully aligned with the existing requirements for other right-of-use assets.

The existing subsequent measurement requirements are based on the applicable requirements in other Standards, without modification other than to address specific characteristics of right-of-use assets. Right-of-use assets arising from leases that are unrelated to sale and leaseback transactions are initially measured at an amount derived from the measurement of other items. In other words, those subsequent measurement requirements are not specifically designed to address particular initial measurements. In line with this, we have not identified specific exceptions that would be required for right-of-use assets arising from a leaseback.

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 are generally supportive of the proposed transition on the basis of the IASB's rationale.

<u>Modified retrospective approach</u>

Based on the current drafting of paragraph C20E(b), it is unclear which date the seller-lessee should use to determine the discount rate, particularly if there has been a change in the lease term or a lease modification before the date of initial application of the amendments. Specifically, it is unclear whether the seller-lessee should apply the original discount rate at the commencement date, or the revised discount rate at the date of change or modification, to the actual payments made before the date of initial application of the amendments.

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Therefore, we suggest that the IASB clarifies the proposed transition, by specifying that the seller-lessee discounts the actual payments made until the date of initial application of the amendments using the rate specified in paragraph 37 of IFRS 16.

We hope that our comments will contribute to the IASB's deliberation on the ED. Should you require any further clarification, please contact our project manager Siok Mun Leong at Leong_Siok_Mun@asc.gov.sg.

Yours faithfully

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