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

Meeting summary of the Leases Advisory Panel ("Panel") of the Financial Reporting Standards Committee ("FRSC") held on Tuesday, 19 January 2021 at 10 a.m. via teleconference.

IASB Exposure Draft ED/2020/4: Lease Liability in a Sale and Leaseback

Background

- Panel members noted that the objective of the meeting was to consult the Panel and seek its feedback regarding the IASB Exposure Draft ED/2020/4: *Lease Liability in a Sale and Leaseback*.

- SSD staff introduced the ED and provided initial staff observations and feedback received from stakeholders to facilitate the discussion.

Panel's feedback

Proposed measurement requirements

1) *Different accounting model and initial gain/loss recognition*

- A Panel member did not support the proposal, and considered that there is no valid reason to move away from the normal lease model (i.e. only to recognise variable lease payments that meet the definition of lease payments). As noted in IFRS 16.BC168, 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. This Panel member suggested the IASB should not develop proposals with significant changes such as in the ED, and should instead keep the current accounting model. This Panel member agreed to follow the principles in paragraph 100(a) of IFRS 16 on how to determine the value of the ROU asset and only partial gain should be recognised on day 1. Following the current accounting model, only variable lease payments depending on an index or rate should be recognised as a the lease liability. Any difference between the sales proceed, gain/loss recognised, ROU asset recognised, lease liability recognised, and the asset sold derecognised, would be accounted for as deferred gain. The deferred gain should be amortised to profit or loss over the lease term on a straight-line or systematic basis. This Panel member stated that this is also his firm's view. This idea was supported by another Panel member who shared a similar experience in his firm, using a similar principle in accounting for the sale and leaseback arrangement. The later member also shared that his firm preferred the deferred gain method (i.e. partial gain recognition on the date of transaction).

- Three Panel members took the view that as the leased asset is retained by the seller-lessee for a period of time after the sale of the asset, the recognition of the gain/loss in full at the date of transaction does not appear conceptually appropriate. However, they had split views on how that residual credit balance (i.e. the remaining balance after recognition of the sales proceeds, the ROU asset, the gains/loss, and the derecognition of asset sold) should be accounted for. One of these Panel members referred to paragraph 100(a) of IFRS 16 and agreed that the entity shall recognise only the amount of gain/loss that relates to the rights transferred to buyer-lessor, and disagreed with the deferred gain concept. He is of the view that as the retained portion is not sold, there can be no gain/loss on the retained portion and so there is no gain to be deferred in the first place. Other members explored whether the consideration received/receivable on the date of transaction consists of both the sales proceeds and the financing provided to the seller-lessee by the buyer-lessor, and hence if the residual credit balance should be accounted for as a financial liability. However, a Panel member disagreed that it is a financing arrangement as there is no contractual obligation for the seller-lessee to pay the buyer-lessor, and thus there should not be any financial liability.

- A Panel member is of the view that the gain/loss on the sale of the asset should be recognised in full at the date of the transaction, and the sale and leaseback arrangement should be accounted for as a new normal lease arrangement. This would be similar to the accounting under US GAAP. This Panel member also mentioned that there is a lack of conceptual basis for treating the variable lease payments for a sale and leaseback arrangement differently from a normal lease arrangement. However, this Panel member also shared a view within his firm in support of the ED's proposals as a short-term fix, since the amendments would reduce diversity in practice. This firm view acknowledged the differences in accounting of lease payments between a sale and leaseback transaction and a normal lease transaction, and suggested the IASB should more fundamentally consider the differences in these two models in the post-implementation review of IFRS 16, but not in the current project.

- Another Panel member shared her firm's global view that the IASB should not prescribe the method in paragraph 100(a)(i) of the ED on how to determine the proportion of RoUA retained as the only acceptable method. The IASB should instead consider if other reasonable alternative treatments would also be acceptable. This Panel member considered that the ED does not improve the current situation, but rather increases the complexity of it. This Panel member also added her personal view that there is no conceptual basis for an entity to be required to estimate the expected lease payments with variable lease payments in a sale and leaseback transaction, but not in a normal lease arrangement. Such changes in principles would be disruptive to preparers, auditors and financial statement users. This Panel member also considered that if the sale of assets is measured at fair value and the leaseback arrangement is carried out at market terms, the gain/loss should be recognised in full, and not deferred to later periods.

2) Remeasurement of lease liabilities

- Panel members generally agreed with staff observations that the hybrid measurement model as introduced in paragraph 102B of the ED, in particular prohibiting remeasurement to reflect a change in future variable lease payments (except for the change in lease term or a lease modification), would not provide a faithful representation of the sale and leaseback arrangement nor provide useful information. Without remeasurement, the relevance of initial estimates of such lease liabilities would decrease over time. They commented that the proposals in the ED may also risk unintended consequences given the internal conflict between the accounting for a normal lease liability and a leaseback liability.

- A Panel member questioned that if the lease liability is remeasured according to paragraph 102B(c) of the ED, whether the impact should be recognised directly in profit or loss. This Panel member held the view that the ROU asset arising from a sale and leaseback arrangement is initially measured in a different way from the ROU asset in a normal lease arrangement. Hence, the method of remeasurement should arguably be different from that applicable to a normal lease, and that the ROU asset arising from a sale and leaseback transaction should not be subsequently adjusted. Under this view, the impact should be recognised in profit or loss. Two more Panel members considered that the impact would likely be recognised in profit or loss. However, another Panel member considered the impact should adjust the ROU asset similar to the normal principle for remeasurement as stated in paragraph 36 of IFRS 16, to avoid structuring opportunities for gains in future periods. The ROU asset would be subject to impairment review as normal.

3) Undefined term - "shortfalls"

- SSD staff observed that the term "shortfalls" is not defined in proposed paragraph 102B of the ED nor is it an existing concept in IFRS 16. It furthermore appears that any shortfalls would be charged to profit or loss directly, and would imply a credit loss event and potentially an implied legal discharge of lease liabilities, which does not sound reasonable. A Panel member explained the mechanics of the shortfalls and mentioned that they would not be charged to profit or loss immediately, but would remain as part of the lease liabilities/other form of liabilities, which aligns with paragraph BC20(b) of the ED. Two panel members agreed that the wording in the proposal is unclear and confusing, and recommended the IASB revisit the wording and clarify the term.

Transition

- A panel member indicated that when applying the proposed transition method in paragraph C20E(b) in calculating the ROU asset using the fact pattern in example 25 of the ED, the amount of the ROU asset would be different from that calculated based on the proposed paragraph 100(a)(i).

Overall comments

- Panel members generally agreed with the SSD staff initial observations and feedback from stakeholders. The majority of members did not support the proposed amendments in the ED, particularly regarding the introduction of a new lease liability model for sale and leaseback transactions. Members considered the following possible alternatives to account for the residual credit balance instead of treating it as a lease liability in the proposal:

- recognised as deferred gain
- recognised as full gain on Day 1
- adjusts the asset valuation
- a financing arrangement

- Panel members commented that the IASB should clarify what are the conceptual differences between the lease liability arising from a normal lease arrangement versus that arising from a sale and leaseback arrangement, leading to accounting for the lease liability differently, and also the rationale as to why there would be no subsequent remeasurement (other than when there is a change in lease term or a lease modification).

Comment letter

- Panel members also discussed the direction of the comment letter. Though Panel members generally did not support the proposal, they acknowledged the difficulties encountered by the IASB to improve the measurement requirements of a sale and lease back transaction. Panel members suggested to include in the comment letter recommendations for the IASB to revisit the proposed model more thoroughly, including considering the conceptual basis and feasibility of the possible alternatives as suggested.

Post-meeting note:

- A Panel member shared the following additional thoughts:
  - agreed with the principle in paragraph 100(a)(i) of the ED that the gain/loss recognised on the date of transaction should be limited to the portion transferred to the buyer-lessor, which is consistent with the existing guidance;
  - supported the determination of the initial measurement of the ROU asset by comparing the present value of expected lease payments (i.e. taking into account the variable lease payments) to the fair value of the asset sold as stated in paragraph 100(a) of the ED;
  - recommended the IASB to further elaborate the term “shortfalls”;
  - agreed with the transition method in the proposal; and
  - overall agreed with other Panel members that the ED does not improve the current situation, but increases complexity and may be misleading.

- A Panel member shared the illustrative calculation of the ROU asset using the transition approach and the fact pattern in example 25 of the ED, and noted a difference in amount with the one calculated under paragraph 100(a).

  SSD staff shared feedback to the Panel member on the illustrative calculation and considered that there is no fundamental issue with the transition provisions in paragraph C20E(b).

Next steps

SSD staff will report the feedback from the Leases Advisory Panel at the 22 February 2021 FRSC meeting, and seek comments from the FRSC, including the direction and content of the comment letter.