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

Comments on the Exposure Draft *Lease Liability in a Sale and Leaseback (Proposed amendments to IFRS 16)*

To the IASB Board Members:

The Japanese Institute of Certified Public Accountants ("we" and "our") appreciates the continued efforts of the International Accounting Standards Board on this project, and welcomes the opportunity to comment on the Exposure Draft *Lease Liability in a Sale and Leaseback (Proposed amendments to IFRS 16)* ("ED").

We agree with the ultimate purpose of IFRS 16 and the ED regarding sale and leaseback transactions that include variable lease payments linked to future performance or use of an underlying asset; that is, no gain or loss on sale should be recognised for the residual proportion of right to use the underlying asset that continues to be economically retained by the seller-lessee via the leaseback. However, we cannot support the ED's proposal to include variable lease payments linked to future performance or use of the underlying asset into the initial measurement of the lease liability and right-of-use asset. This is because it appears to be inconsistent with the general principles of IFRS 16 and also does not seem to meet the definition of a liability under IFRS. As basis for the proposal is not sufficiently explained in the ED, we are concerned it may disrupt the understandability of financial statements users.

Please find our comments to the questions raised in the ED, in the following pages.

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.

Comment:

We disagree with the proposal.

We agree with the ultimate purpose of IFRS 16 and the ED regarding sale and leaseback transactions that include variable lease payments linked to future performance or use of an underlying asset; that is, no gain or loss on sale should be recognised for the residual proportion of right to use the underlying asset that continues to be economically retained by the seller-lessee via the leaseback. However, we do not agree with the ED's proposal to include variable lease payments linked to future performance or use of the underlying asset into the initial measurement of the lease liability and right-of-use asset. This is because it appears to be inconsistent with the general principles of IFRS 16 and also does not seem to meet the definition of a liability under IFRS. We believe further clarification is required to support the IASB's argument.

- According to paragraphs BC7 and BC11 of the Basis for Conclusions in the ED, paragraph 100(a) of IFRS 16 is requiring variable lease payments linked to future performance or use of the underlying asset that do not depend on an index or rate (and that are not in-substance fixed payments), that is, those that do not meet the definition of lease payments, to be included in the initial measurement of the lease liability arising in a sale and leaseback transaction. Because of this requirement regarding the initial measurement, the IASB is arguing that the accounting for subsequent measurement should align with that for initial measurement. However, given that such variable lease payments do not meet the definition of lease payments under IFRS 16, it is uncertain as to how such interpretation regarding the initial measurement can be justified by the IASB, even with the support of the requirement in paragraphs 98 and BC266 of IFRS 16, which specifies paragraphs 99-103 of IFRS 16 should be referred to instead of other general requirements in IFRS 16. Consequently, we believe the IASB should come up with a stronger logic that underpins the ED's proposal.

- According to paragraphs BC10(d), BC168 and BC169 of IFRS 16, the Board decided to exclude variable lease payments linked to future performance or use of the underlying asset from the measurement of lease liabilities under IFRS 16 due to the following reasons: 1) costs would outweigh benefits due to high level of measurement uncertainty; and 2) payments based on future performance or use do not meet the definition of a liability. Regarding 1), BC19 of the ED provides reasons for seller-lessees to be able to reasonably estimate the expected lease payments; however, they do not seem to be persuasive enough as a fundamental reason as to why the accounting for leaseback transactions can be differentiated from other lease transactions. Further, even if a reasonable estimate is possible at the time of initial recognition, there is no guarantee that the same would apply to remeasurements that occur due to extension of lease periods or lease modifications. Regarding 2), no detailed explanation is even provided in the ED. The argument made in BC14 of the ED is also applicable to leases other than sale and leaseback transactions. Further, we do not think that the discussion in paragraphs BC14 and BC15 of the ED are convincing enough as reasons as to why only sale and leaseback transactions are allowed to include variable lease payments linked to future performance or use of an underlying asset in measuring lease liabilities. Given that the IASB recognises payments based on future performance or use do not meet the definition of a liability, we are more or less concerned that financial statements users' understanding of general principles of IFRS 16 could be significantly impaired by providing a separate measurement requirement within IFRS 16 for payments that clearly do not meet the definition of lease payments and presenting them as part of lease liabilities.

We understand that the ultimate purpose of IFRS 16 and the ED is to prevent seller-lessees from recognising any gain or loss on the residual proportion they economically retain under sale and leaseback transactions.

If so, we suggest the IASB should somehow develop a new accounting requirement that does not contradict with the general requirement in IFRS 16 to justify the accounting treatment for not recognising gain or loss on the residual proportion economically retained by an entity.

Regardless of the above comments, we recommend the IASB to reconsider the following in case it proceeds with finalising the standard based on the proposed ED.

- Should the IASB decide to develop a measurement requirement for sale and leaseback transactions that does not align with the general principles of IFRS 16 related to lease liabilities, we recommend that further clarification should be made for the definition of sale and leaseback transactions. The classification could become more important from an accounting perspective, depending on whether it is either a sale and leaseback transaction or a separate transaction to be accounted for separately between sale and lease.

- According to 100(a)(i) and IE12 Example 25 of the ED, the seller-lessee shall initially measure right-of-use assets and lease liabilities at the present value of expected lease payments, which include variable lease payments that do not depend on an index or rate, discounted using the interest rate implicit in the lease (or the lessee's incremental borrowing rate) as specified in IFRS16.26. However, the interest rate implicit in the lease, by definition, is not supposed to reflect variable lease payments that do not depend on an index or rate. As a result, the outcome of present value would be inappropriate, deviated from the original concept. Thus, we suggest 100(a)(i) of the ED should explicitly state that a risk factor related to variable lease payments that do not depend on an index or rate should be incorporated in the measurement requirement.

- A clear explanation is required for the term 'expected' used in 'expected lease payments' in paragraph 100 and paragraphs 100A onwards of the ED to enhance stakeholders' understanding. For example, does it mean an amount is determined based on probability weighted average or on an entity's best estimate based on the most likely outcome and/or other factors?

- In order to improve the understandability of financial statements, additional disclosure is highly recommended for the breakdown of lease liabilities, showing amounts related to sale and leaseback transactions and those related to other leases. Moreover, the calculation basis should also be disclosed for lease liabilities, right-of-use assets and gain or loss on sale associated with sale and leaseback transactions as proposed in the ED, given that the amounts involve a lot of estimates and assumptions to be derived. Further, the following disclosure requirements should be clearly stated in the finalised standard: presentation requirement when actual lease payments are lower than expected lease payments (i.e. when gain is recognised); and the cashflow classification as well as the liability reconciliation under IAS 7 regarding the difference between actual lease payments and expected lease payments.

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.

Comment:

<Request on addressing first-time adoption>

If the IASB were to proceed with the finalisation based on the proposed ED, we would agree with the transition proposal. That said, we recommend the IASB to consider the following regarding the accounting for first-time adoption:

- The current IFRS 1 does not specify any exemptions for sale and leaseback transactions. Moreover, it is quite uncertain as to how such transactions fit into the existing exemption requirements for revenue (paragraphs D34 and D34 of IFRS 1) and leases (paragraphs D9-D9E of IFRS 1). If the IASB plans to reconsider the accounting for sale and leaseback transactions, introducing an accounting treatment completely different from that for general lease transactions, then we suggest that an exemption should be set out for first-time adopters.

<Other comments>

We believe the logic behind the discussions made in paragraph BC266 of IFRS 16 and paragraph BC10 of the ED contradicts with the application of IFRS 16 to sale and leaseback transactions. Accordingly, when going through post-implementation reviews for IFRS 16, we highly recommend that the IASB step back and reconsider an appropriate accounting treatment for sale and leaseback transactions as well as a clear logic supporting the accounting.

・ Paragraph BC266 of IFRS 16 and paragraph BC10 of the ED provide that although, in many cases, an entity (or the seller) may have legally transferred the ownership of the entire underlying asset, part of the underlying asset still includes the right-of-use from an economic perspective, meaning that the entity (or seller) has retained that part of the asset during the period of the lease without transferring it to the buyer, thus need not recognise any gain or loss for the retained part. In other words, the entity (or the seller) has transferred only its interest in the value of the underlying asset at the end of the leaseback. However, technically speaking, it is not possible for the seller to lease the right-of-use that is never transferred to the buyer. In order to account for the transaction as a lease, the entire underlying asset first needs to be transferred to the buyer via the leaseback. In fact, IFRS 16 stipulates that an entity should consider whether or not the transfer of the entire underlying asset meets the requirement of IFRS 15 to be accounted for as a sale of the asset in assessing sale and leaseback transactions. This IFRS 16 requirement may contradict with the concept in paragraph BC266 of IFRS 16 and paragraph BC10 of the ED, indicating that sale and leaseback transactions are accounted for based on an assumption that the right-of-use included in the underlying asset is not transferred to the buyer.

Yours faithfully,

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Executive Board Member － Business Accounting Standards and Practice/Corporate Disclosure
The Japanese Institute of Certified Public Accountants