Arab Pioneers Group
APG
Chartered Accountants & Consultants

Comment on Tentative Agenda Decision and comment letters: Sale and Leaseback with Variable Payments (IFRS 16)

Dear colleagues ,,

I would like to thank you all , for the bright recognized efforts you performed in the tentative agenda decision of sale and leaseback with variable payments , in addition the example was extremely useful to clearly describe the committee decision .

I found such generous opportunity to provide some suggestions to improve decision reached which might be advantageous in process of further deliberations in considerations with other comments and analysis .

I regret not to agree with the decision of the committee at this time , the justifications and the consequent suggested amendments of such conclusion are accompanied with my letter (Page 2-4).

Kindly , if you need any further explanations in relation to the attached conclusion or suggested amendment , it will be my pleasure to respond in fully to you using below contact.

Thanks

Your sincerely ,,

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Basis of conclusion and suggested amendments :

I do not agree with committee's decision , I think the committee's decision ignored IFRS 16 Par.27(b) and 28 in which lease liability' composition was determined at initial measurement to include only variable payments linked to rate or index at commencement of lease .

it was indicted in the committee decision "*the seller-lessee also* <u>*recognizes a lease liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate*</u>*. The initial measurement of the lease* <u>*liability is a consequence of how the right-of-use asset is measured*</u>*— and the gain or loss on the sale and leaseback transaction determined—*"

Applying the previous paragraph Par.100(a) IFRS 16, although achieve its objective of measuring retained right of use of assets and gain to that extent but does not provide clear conclusion about the liability , in my opinion , such paragraph is not aligned with the workings of the example presented . the example's workings has one of its steps determined the right of use of assets using proportionate method based on present value of expected variable payments divided into FMV of PPE , accordingly the present value of expected payment ,which is the major part of composition of any lease liability , would have affected the measurement of right of use of assets and its outcome lease liability . while Par.100(a) focus on measuring of carrying value of right of use of asset which is transferred ,there is no direct criteria for measuring lease liability in such paragraph . in addition , the resulted lease liability is not expected to differ from the PV of expected payment of lease , no other event or condition make it logic that lease liability will be different from criteria stated in Par.27(b)which represent the general rule for measurement of lease liability. In consequence, the inclusion of expected variable payments is indirectly affect the liability ,and if not , then we have to conclude that 450,000 consist of right of use of asset and part of gain unrecognized , while depending on that hypothetical assumption , will need to consider the different accounting behavior of both accounts .

if we consider the present value of expected variable payment of lease in context of determination of right of use of asset(as committee concluded it is a consequence of retained right od use of asset) , this will be a contradiction of unit of account concept as The use of present value of expected variable payments and lease liability as a unit of accounts does have the same characteristics . it is an obligation which assumes time value of money and represent obligation with two types of change interest expense and payment cashflow . although it is in exchange of measured right of use of asset in context of what is retained by seller lessee , it reflects payment considerations for the right of use of asset and interest due to time value of money (i.e same common economic characteristics and pattern of expiration are reflected for both lease liability and the PV of variable payments) . Accordingly treating that liability differently from normal lease liability, taking in considerations assumption of calculation of such liability as a consequence of right of use of asset , will not be aligned with

Framework and the associated unit of account concept of this liability (conceptual Framework for financial reporting issued March 2018 , Par 4.51(ii),(iii))

in addition , As a consequence in Subsequent to measurement , in case of asset suspension from operation , no revenues will be generated from the asset and in this case lease liability modification which not represent separate lease , it will be accounted for using Par .45-46 , and impairment may be indicated under Par.30 " cost model" . As a result, the effect of capitalizing lease liability and corresponding right of use of asset will not represent the substance of the transaction by recognition of gain when liability extinguished and impairment of asset .Instead ,i suggest that the variable rent payment is recognized as expense when incur since it is not linked to index or rate . This will be aligned with Par. 38 (b) . In addition , Recognition of expense will be faithfully representing the lease substance when asset performance is nill then no expense or revenues are expected to be recognized cause rent expense is linked to usage of asset . rent expense is will be recognized only when performance of related asset generates revenues. From my point of view , this is better achieve matching .

As an alternative *, in conjunction with the framework of financial reporting , Par 4.53 Sometimes, both rights and obligations arise from the same source. For example, some contracts establish both rights and obligations for each of the parties. If those rights and obligations are interdependent and cannot be separated, they constitute a single inseparable asset or liability form a single unit of account , accordingly if committee determined liability as consequence of measuring retained asset , another conclusion will have come to minds as a consequence .*

Nevertheless, The related part of unit of account which represent right of use of asset may not relate to the liability as it relates to rights from the asset remaining as a consequence of sale , both accounts still relate to one of source of transaction . In addition , rights and obligations are interdependent of both parties and cannot be separated ,accordingly , suggestion may be concluded that only liability or asset shall be recognized, and accordingly single inseparable asset or liability is presented.

So that , I suggest that the liability is recognized only when satisfy recognition criteria of financial liability(IFRS 9) to extent of right of use of asset retained (not transferred) , if not align with criteria of Par.27. In addition , entity may elect not to defer unrecognized gain (reduce right of use of asset to extent of that amount).

In so far , This will Align partially with (Par 103(a)) ,as liability can be measured to extent of those untransferable rights of use not subject to sale (i.e excess of considerations received over transferable rights and gain either recognized or deferred).

In case of variable payments , degree of uncertainty may impact recognition , so associated asset and liabilities due to uncertainty may depend on same uncertainty and offsetting may be justifiable in such case .

*I think committee may consider in further deliberations , other cases which affect whether sale and lease back in substance is a financial liability , especially when we consider **that IFRS 15 consider only some circumstances that may affect sale and lease back , these cases most likely depend on factors such as repurchase agreement and was not clear regard impacts of other***

factors of lease back agreement such as lease term in relation to asset useful life or PV's sustainability in subject to FV (i.e instead , if PV of expected variable payment was 1,350,000 *which would represent 75% of FMV) and lease back is classified as finance lease .*

In accordance to aforementioned criteria of measuring such liability as financial liability , the following is suggested criteria to measure such financial liability and gain *:*

The gain of sale attribute to derecognition of asset which satisfy IFRS 15 criteria subject to IAS 16 Par 68 which refer to IFRS 16 will be appropriately recognized , as in context of IFRS 16 Par. 100 it is required to recognize gain or loss from sale that attribute to rights transferred . The remaining portion which is not satisfying gain recognition criteria (deferred), will be treated as financial liability, by the difference between cash and right of use of asset over the asset 's CV and gain deferred& recognized amounted 450,000(1,800,000-1,350,000)

Accordingly , the amount represent excess of FMV and right od use retained interest over Asset's CV and which cannot be seen as gain or represent deferred gain (not sustained through consideration attribute to part transferred) shall be recognized as financial liability in line with Par 103 (a) . (i.e when part of rights does not satisfy the sale in accordance to IFRS 15 " the seller-lessee shall continue to recognize the transferred asset and shall recognize a financial liability equal to the transfer proceeds " .

(a) The right of use of assets retained proportionately calculated as apart from CV as the committee's example indicated 250,000 .
(b) The gain should be recognized by the difference between the net disposal proceeds and the carrying amount of the item .the attribute proceeds to sale shall be determined proportionately by reference to transferred right /total rights (FMV)1800000 1350,000/1,800,000 = 1350,000*
(c) Accordingly ,gain's ceiling is recognized subject to difference between sale's attributable consideration and CV = (1350,000-1000,000 CV) = 350,000.
(d) The remaining deferred gain 250,000(600,000-350,000) This reflect prudence rather than using gain over transferred portion of carrying value proportionately
(e) The lease liability is recognized to extent of excess of considerations received over asset's CV , recognized, and deferred gain (1800,000+250000 (right of use of asset)-1000,000-250,0000-350000) 450,000.

The suggested journal entry*:*

Dr. cash 1800,000

Dr. right of use of asset 250,000

Cr Asset 1000,000

Cr gain 350,000

** Cr. deferred gain 250,000*

Cr lease liability 450,000

- *Entity may elect to offset such deferred gain to right of use of asset in case of expected variable payment*

Suggested IFRS 16 Par.100 after modification

If the transfer of an asset by the seller-lessee satisfies the requirements of

IFRS 15 to be accounted for as a sale of the asset:

(a) *the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognize only the amount of any gain or loss that relates to* ***proceeds attribute to disposal*** *of the rights transferred to the buyer-lessor .*

(b) ***The gain in (a) is recognized subject to ceiling in accordance with criteria of IAS 16 Par.71***

(c) ***To extent of gain attribute to transferred asset in (a) in excess of gain's ceiling in (b) , gain should be deferred and amortized over lease term if lease is classified as operating lease or in proportionate to decrease in PV, entity may irrevocably elect to reduce right of use of asset by to extent of such gain .***

(d) ***Remaining proceeds should be recognized as lease liability as required by Par.27 ,otherwise it is considered financial liability to extent to right of use of assets not consider to be transferred in sale .***