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Exposure Draft ED/2020/4

# Lease Liability in a Sale and Leaseback

## Proposed amendment to IFRS 16

Comments to be received by 29 March 2021

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 IFRS<sup>®</sup>

# **Exposure Draft**

## **Lease Liability in a Sale and Leaseback**

### **Proposed amendment to IFRS 16**

*Comments to be received by 29 March 2021*

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## Introduction

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In this Exposure Draft, the International Accounting Standards Board (Board) proposes to amend IFRS 16 *Leases*. The proposed amendment would specify the method a seller-lessee uses in initially measuring the right-of-use asset and liability arising in a sale and leaseback transaction and how the seller-lessee subsequently measures that liability. The proposed amendment 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.

### Why is the Board publishing this Exposure Draft?

The IFRS Interpretations Committee (Committee) received a request about a sale and leaseback transaction that includes variable lease payments. The request asked how the seller-lessee measures the right-of-use asset arising from the leaseback and, thus, determines any gain or loss to recognise at the date of the transaction. The Committee concluded that IFRS 16 provides an adequate basis for a seller-lessee to determine the accounting for the sale and leaseback transaction at the date of the transaction and published an agenda decision explaining this conclusion.

However, the Committee's discussions on this matter highlighted the absence of specific subsequent measurement requirements for sale and leaseback transactions in IFRS 16. The Board was informed that diverse views on how to subsequently measure the liability arising in a sale and leaseback transaction could lead to material differences in the financial statements of seller-lessees that enter into such transactions. The Board, therefore, proposes to amend IFRS 16 to add subsequent measurement requirements for sale and leaseback transactions. To facilitate this proposed amendment, the Board is also proposing to specify the method a seller-lessee uses in initially measuring the right-of-use asset and liability arising in such transactions.

The proposal set out in this Exposure Draft would improve the requirements for sale and leaseback transactions in IFRS 16. The proposal would change neither the principles for the sale and leaseback requirements in IFRS 16 nor the accounting for leases unrelated to sale and leaseback transactions.

## Invitation to comment

The Board invites comments on the proposal in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

- (a) address the questions as stated;
- (b) indicate the specific paragraph(s) to which they relate;
- (c) contain a clear rationale;
- (d) identify any wording in the proposal that is difficult to translate; and
- (e) include any alternative the Board should consider, if applicable.

The Board is requesting comments only on matters addressed in this Exposure Draft.

## Questions for respondents

### 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.

### 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.

## **Deadline**

The Board will consider all written comments received by 29 March 2021.

## **How to comment**

Please submit your comments electronically:

Online	<a href="https://www.ifrs.org/projects/open-for-comment/">https://www.ifrs.org/projects/open-for-comment/</a>
By email	<a href="mailto:commentletters@ifrs.org">commentletters@ifrs.org</a>

Your comments will be on the public record and posted on our website unless you request confidentiality and we grant your request. We do not normally grant such requests unless they are supported by a good reason, for example, commercial confidence. Please see our website for details on this policy and on how we use your personal data.

**[Draft] Amendment to IFRS 16 Leases**

Paragraphs 100, 102 and C2 are amended and paragraphs 100A, 102A–102B, C1C and C20E are added. A new heading is added before paragraph C20E. New text is underlined, and deleted text is struck through.

**Sale and leaseback transactions**

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...

**Assessing whether the transfer of the asset is a sale**

...

**Transfer of the asset is a sale**

100 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:
  - (i) initially 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. The seller-lessee shall determine that proportion by comparing the present value of the expected lease payments (see paragraph 100A), discounted using the rate specified in paragraph 26, to the fair value of the asset sold. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.
  - (ii) recognise a lease liability arising from the leaseback. The seller-lessee shall initially measure the lease liability at the present value of the expected lease payments (see paragraph 100A) that are not paid at the commencement date, discounted using the rate specified in paragraph 26.

...

100A For the purposes of applying paragraphs 100–102B, the expected lease payments comprise the following payments relating to the right to use the asset during the lease term at market rates:

- (a) fixed payments (including in-substance fixed payments), less any lease incentives;
- (b) variable lease payments (regardless of whether they depend on an index or a rate);
- (c) amounts expected to be payable by the seller-lessee under residual value guarantees; and
- (d) payments of penalties for terminating the lease, if the lease term reflects the seller-lessee exercising an option to terminate the lease.



...

102 The entity shall measure any potential adjustment required by paragraph 101 on the basis of the more readily determinable of:

- (a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and
- (b) the difference between the present value of the contractual payments for the lease and the present value of the expected lease payments~~payments for the lease at market rates~~.

102A The seller-lessee shall subsequently measure:

- (a) the right-of-use asset arising from the leaseback applying paragraphs 29–35.
- (b) the lease liability arising from the leaseback applying paragraph 102B.

102B The seller-lessee shall subsequently measure the lease liability arising from the leaseback by:

- (a) increasing the carrying amount to reflect interest on the lease liability (see paragraph 37).
- (b) reducing the carrying amount to reflect the expected lease payments for the reporting period as determined at the commencement date, or if applicable the revised expected lease payments for the reporting period as determined at the date of remeasurement.
- (c) remeasuring the carrying amount as specified in paragraph 36(c), except in the circumstances described in paragraph 42(b). In applying paragraphs 40(a) and 45, the revised lease payments as described in those paragraphs shall be the revised expected lease payments at the date of remeasurement. Except for a change in the lease term or a lease modification (see paragraphs 40(a) and 45), the seller-lessee shall not remeasure the lease liability to reflect a change in future variable lease payments.
- (d) recognising any difference between the actual payments made for the lease (excluding any above-market terms described in paragraph 101(b)) and the expected lease payments for the reporting period as specified in paragraph 38. If there are shortfalls in the actual payments made (ie the payments made are less than the payments due) or recoveries of shortfalls, the seller-lessee shall also adjust the carrying amount of the lease liability and make a corresponding adjustment as specified in paragraph 38.

...

## Appendix C Effective date and transition

### Effective date

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...

C1C [Draft] *Lease Liability in a Sale and Leaseback*, issued in [Month Year], amended paragraphs 100, 102 and C2 and added paragraphs 100A, 102A–102B and C20E. A seller-lessee shall apply that amendment for annual reporting periods beginning on or after [date to be decided after exposure]. Earlier application is permitted.

### Transition

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C2 For the purposes of the requirements in paragraphs C1–~~C20E~~C19, the date of initial application is the beginning of the annual reporting period in which an entity first applies this Standard.

...

### **Lease liability in a sale and leaseback**

C20E A seller-lessee shall apply [Draft] *Lease Liability in a Sale and Leaseback* (see paragraph C1C) retrospectively in accordance with IAS 8 to sale and leaseback transactions entered into after the date of initial application. However, if retrospective application to a sale and leaseback transaction that includes variable lease payments would be possible only with the use of hindsight, the seller-lessee shall determine the expected lease payments (see paragraph 100A) for that transaction at the beginning of the annual reporting period in which the seller-lessee first applies the amendment (date of initial application of the amendment). In such circumstances, the seller-lessee shall:

- (a) measure the lease liability arising from the leaseback at the present value of the remaining expected lease payments at the date of initial application of the amendment, discounted using the rate specified in paragraph 37;
- (b) measure the right-of-use asset arising from the leaseback at its carrying amount as if the amendment had been applied since the commencement date, but measured using the remaining expected lease payments at the date of initial application of the amendment plus the actual payments made for the lease until that date; and
- (c) recognise the cumulative effect of applying the amendment as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application of the amendment.

## [Draft] Amendment to Illustrative Examples accompanying IFRS 16

### Sale and leaseback transactions (paragraphs 98–103)

Illustrative Example 24 has been amended. New text is underlined, and deleted text is struck through. In this illustrative example, the headings 'Seller-lessee' and 'Buyer-lessor' are not amended; they are reproduced the way they appear in the published illustrative examples.

- IE11 Example 24 illustrates the application of the requirements in paragraphs 99–102 of IFRS 16 for a seller-lessee and a buyer-lessor.

**Example 24—Sale and leaseback transaction with fixed payments and above-market terms**

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU2,000,000. Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of CU120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15 Revenue from Contracts with Customers. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback. ~~This example ignores any initial direct costs.~~

The fair value of the building at the date of sale is CU1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. Applying paragraph 101(b) of IFRS 16, the amount of the excess sale price of CU200,000 (CU2,000,000 – CU1,800,000) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

The interest rate implicit in the lease is ~~4.5% per cent per year~~annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of CU120,000, discounted at ~~4.5% per cent per year~~annum) ~~is~~amounts to CU1,459,200, of which CU200,000 relates to the additional financing and CU1,259,200 relates to the lease – corresponding to 18 annual payments of CU16,447 and CU103,553, respectively.

Buyer-lessor classifies the lease of the building as an operating lease.

continued...

...continued

**Example 24—Sale and leaseback transaction with fixed payments and above-market terms**Seller-lessee

At the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building by comparing the present value of the expected lease payments, discounted using the interest rate implicit in the lease, to the fair value of the building (paragraph 100(a)(i) of IFRS 16) at the proportion of the previous carrying amount of the building that relates to the right of use retained by Seller-lessee, which is CU699,555. On this basis, Seller-lessee measures the right-of-use asset at CU699,555. This is calculated as:  $CU1,000,000$  (the carrying amount of the building)  $\div$   $CU1,800,000$  (the fair value of the building)  $\times$   $CU1,259,200$  (the present value of the expected lease payments)  $\div$   $CU1,800,000$  (the fair value of the building).

The gain on sale of the building is CU800,000 ( $CU1,800,000 - CU1,000,000$ ). Applying paragraph 100(a)(i) of IFRS 16, Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of CU240,355 calculated as follows. The gain on sale of building amounts to  $CU800,000$  ( $CU1,800,000 - CU1,000,000$ ), of which:

- (a)  $CU559,645$  ( $CU800,000 \div CU1,800,000 \times CU1,259,200 \div CU1,800,000$ ) relates to the right to use the building retained by Seller-lessee; and
- (b)  $CU240,355$  ( $CU800,000 \div CU1,800,000 \times (CU1,800,000 - CU1,259,200) \div CU1,800,000$ ) relates to the rights transferred to Buyer-lessor.

continued...

...continued

<b>Example 24—Sale and leaseback transaction with fixed payments and above-market terms</b>	
At the commencement date, Seller-lessee accounts for the transaction as follows.	
Cash	CU2,000,000
Right-of-use asset	CU699,555
Building	CU1,000,000
<u>Lease liability</u>	<u>CU1,259,200<sup>(a)</sup></u>
Financial liability	<u>CU200,000</u>
	CU1,459,200
Gain on rights transferred	CU240,355
<u>Buyer-lessor</u>	
At the commencement date, Buyer-lessor accounts for the transaction as follows.	
Building	CU1,800,000
Financial asset	CU200,000 (18 payments of CU16,447, discounted at 4.5% per cent per year <del>annum</del> )
Cash	CU2,000,000
After the commencement date, Buyer-lessor accounts for the lease by treating CU103,553 of the annual payments of CU120,000 as lease payments. The remaining CU16,447 of annual payments received from Seller-lessee are accounted for as (a) payments received to settle the financial asset of CU200,000 and (b) interest revenue.	
(a) <u>Applying paragraph 100(a)(ii) of IFRS 16, the initial measurement of the lease liability arising from the leaseback equals the present value of the expected lease payments, discounted in this example using the interest rate implicit in the lease.</u>	

Paragraph IE12 and Illustrative Example 25 are added. This paragraph and illustrative example have not been underlined for ease of reading.

- IE12 Example 25 illustrates the application of the requirements in paragraphs 99–102B of IFRS 16 for a seller-lessee in a sale and leaseback transaction with variable lease payments.

**Example 25—Sale and leaseback transaction with variable lease payments**

*Part 1 – Sale of an item of property, plant and equipment, and recognition and measurement of the right-of-use asset and lease liability arising from the leaseback*

*An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU1,800,000 (the fair value of the building at the date of sale). Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for five years. The contract requires Seller-lessee to make annual payments calculated as 7% of Seller-lessee’s revenue generated using the building during each of the five years, with an annual minimum payment of CU85,000 in each year (the payments are at market rates). The estimated revenue and expected lease payments for each of the five years are:*

	<b>Estimated revenue</b>	<b>Expected lease payments</b>
<b>Year</b>	<b>CU</b>	<b>CU</b>
1	1,300,000	91,000
2	1,400,000	98,000
3	1,450,000	101,500
4	1,480,000	103,600
5	1,500,000	105,000

*The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15 Revenue from Contracts with Customers. Accordingly, Seller-lessee accounts for the transaction as a sale and leaseback.*

*The interest rate implicit in the lease cannot be readily determined. Seller-lessee’s incremental borrowing rate is 3.5% per year. The present value of the expected lease payments (discounted at 3.5% per year) is CU449,642.*

continued...

...continued

<b>Example 25—Sale and leaseback transaction with variable lease payments</b>											
<p>At the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building by comparing the present value of the expected lease payments, discounted using its incremental borrowing rate, to the fair value of the building (paragraph 100(a)(i) of IFRS 16). On this basis, Seller-lessee measures the right-of-use asset at CU249,801, calculated as: <math>CU1,000,000</math> (the carrying amount of the building) <math>\times</math> <math>CU449,642</math> (the present value of the expected lease payments for the five-year right-of-use asset) <math>\div</math> <math>CU1,800,000</math> (the fair value of the building).</p> <p>The gain on sale of the building is <math>CU800,000</math> (<math>CU1,800,000 - CU1,000,000</math>). Applying paragraph 100(a)(i) of IFRS 16, Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of <math>CU600,159</math> calculated as follows:</p> <p>(a) <math>CU199,841</math> (<math>CU800,000 \times CU449,642 \div CU1,800,000</math>) relates to the right to use the building retained by Seller-lessee; and</p> <p>(b) <math>CU600,159</math> (<math>CU800,000 \times (CU1,800,000 - CU449,642) \div CU1,800,000</math>) relates to the rights transferred to Buyer-lessor.</p> <p>At the commencement date, Seller-lessee accounts for the transaction as follows:</p> <table> <tbody> <tr> <td>Cash</td> <td>CU1,800,000</td> </tr> <tr> <td>Right-of-use asset</td> <td>CU249,801</td> </tr> <tr> <td>    Building</td> <td>CU1,000,000</td> </tr> <tr> <td>    Lease liability</td> <td>CU449,642<sup>(a)</sup></td> </tr> <tr> <td>    Gain on rights transferred</td> <td>CU600,159</td> </tr> </tbody> </table> <p><i>Part 2A—Subsequent measurement</i></p> <p><i>Seller-lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis. Seller-lessee pays CU92,000 in Year 1, CU96,000 in Years 2 and 3 and CU104,000 in Years 4 and 5 for the lease (calculated as 7% of Seller-lessee's revenue generated using the building).</i></p>		Cash	CU1,800,000	Right-of-use asset	CU249,801	Building	CU1,000,000	Lease liability	CU449,642 <sup>(a)</sup>	Gain on rights transferred	CU600,159
Cash	CU1,800,000										
Right-of-use asset	CU249,801										
Building	CU1,000,000										
Lease liability	CU449,642 <sup>(a)</sup>										
Gain on rights transferred	CU600,159										

continued...

...continued

**Example 25—Sale and leaseback transaction with variable lease payments**

The right-of-use asset and the lease liability arising from the leaseback are:

Year	Lease liability				Right-of-use asset		
	Beginning balance	Expected lease payments <sup>(b)</sup>	3.5% interest expense <sup>(c)</sup>	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
1	449,642	(91,000)	15,738	374,380	249,801	(49,960)	199,841
2	374,380	(98,000)	13,103	289,483	199,841	(49,960)	149,881
3	289,483	(101,500)	10,132	198,115	149,881	(49,960)	99,921
4	198,115	(103,600)	6,934	101,449	99,921	(49,960)	49,961
5	101,449	(105,000)	3,551	-	49,961	(49,961)	-

Applying paragraph 102B(d) of IFRS 16, Seller-lessee recognises in profit or loss the difference between the actual payments made for the lease and the expected lease payments (there are no shortfalls in the actual payments made):

Year	Actual payments made for the lease	Expected lease payments	Difference in profit or loss
	CU	CU	CU
1	92,000	91,000	(1,000)
2	96,000	98,000	2,000
3	96,000	101,500	5,500
4	104,000	103,600	(400)
5	104,000	105,000	1,000

*Part 2B—Subsequent measurement including a lease modification*

Assume the same facts as Part 2A except that at the beginning of Year 3, Seller-lessee and Buyer-lessor agree to amend the original lease to calculate the annual payments for the lease as 6% of Seller-lessee's revenue generated using the building for the remainder of the lease term (from Year 3 to Year 5), with the same minimum annual payment of CU85,000. Seller-lessee's estimated revenue from Year 3 to Year 5 remains unchanged. Seller-lessee's incremental borrowing rate at the beginning of Year 3 is 3% per year. Seller-lessee determines the revised expected lease payments as follows:

continued...



...continued

<b>Example 25—Sale and leaseback transaction with variable lease payments</b>							
<b>Year</b>	<b>Estimated revenue CU</b>	<b>Expected lease payments (revised) CU</b>					
3	1,450,000	87,000					
4	1,480,000	88,800					
5	1,500,000	90,000					

Seller-lessee pays CU88,000 in Years 3 and 4 and CU92,000 in Year 5 for the lease (calculated as 6% of Seller-lessee's revenue generated using the building).

The pre-modification right-of-use asset and the pre-modification lease liability arising from the leaseback are:

Year	Lease liability				Right-of-use asset		
	Beginning balance	Expected lease payments	3.5% interest expense	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
1	449,642	(91,000)	15,738	374,380	249,081	(49,960)	199,841
2	374,380	(98,000)	13,103	289,483	199,841	(49,960)	149,881
3	289,483				149,881		

Applying paragraph 102B(c) of IFRS 16, at the effective date of the modification (at the beginning of Year 3), Seller-lessee remeasures the lease liability based on: (a) the revised expected lease payments of CU87,000 in Year 3, CU88,800 in Year 4 and CU90,000 in Year 5, and (b) Seller-lessee's revised incremental borrowing rate of 3% per year. Applying paragraph 46(b) of IFRS 16, Seller-lessee recognises the difference between the carrying amount of the modified liability (CU250,531) and the lease liability immediately before the modification (CU289,483) of CU38,952 as an adjustment to the right-of-use asset.

Lease liability	CU38,952
Right-of-use asset	CU38,952

The modified right-of-use asset and the modified lease liability arising from the modified leaseback are:

continued...

...continued

<b>Example 25—Sale and leaseback transaction with variable lease payments</b>							
Year	Lease liability				Right-of-use asset		
	Beginning balance	Expected lease payments <sup>(d)</sup>	3% interest expense <sup>(e)</sup>	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
3	250,531	(87,000)	7,516	171,047	110,929	(36,976)	73,953
4	171,047	(88,800)	5,132	87,379	73,953	(36,976)	36,977
5	87,379	(90,000)	2,621	-	36,977	(36,977)	-

Applying paragraph 102B(d) of IFRS 16, Seller-lessee recognises in profit or loss the difference between the actual payments made for the lease and the expected lease payments (there are no shortfalls in the actual payments made):

Year	Actual payments made for the lease	Expected lease payments	Difference in profit or loss
	CU	CU	CU
1	92,000	91,000	(1,000)
2	96,000	98,000	2,000
3	88,000	87,000	(1,000)
4	88,000	88,800	800
5	92,000	90,000	(2,000)

(a) Applying paragraph 100(a)(ii) of IFRS 16, the initial measurement of the lease liability arising from the leaseback equals the present value of the expected lease payments, discounted in this example using Seller-lessee’s incremental borrowing rate.

(b) Applying paragraph 102B(b) of IFRS 16, Seller-lessee reduces the carrying amount of the lease liability to reflect the expected lease payments as determined at the commencement date.

(c) Applying paragraph 102B(a) of IFRS 16, Seller-lessee increases the carrying amount of the lease liability to reflect interest on the lease liability using its incremental borrowing rate in this example.

(d) Applying paragraph 102B(b) of IFRS 16, Seller-lessee reduces the carrying amount of the lease liability to reflect the expected lease payments as determined at the date of remeasurement.

(e) Applying paragraph 102B(a) of IFRS 16, Seller-lessee increases the carrying amount of the lease liability to reflect interest on the lease liability using its revised incremental borrowing rate in this example.

**Approval by the Board of Exposure Draft *Lease Liability in a Sale and Leaseback* published in November 2020**

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The Exposure Draft *Lease Liability in a Sale and Leaseback*, which proposes an amendment to IFRS 16 *Leases*, was approved for publication by 12 of 13 members of the International Accounting Standards Board. Ms Flores voted against its publication. Her alternative view is set out after the Basis for Conclusions.

Hans Hoogervorst	Chairman
Suzanne Lloyd	Vice-Chair
Nick Anderson	
Tadeu Cendon	
Martin Edelmann	
Françoise Flores	
Zach Gast	
Jianqiao Lu	
Bruce Mackenzie	
Thomas Scott	
Rika Suzuki	
Ann Tarca	
Mary Tokar	

## **Basis for Conclusions on Exposure Draft *Lease Liability in a Sale and Leaseback***

*This Basis for Conclusions accompanies, but is not part of, the Exposure Draft Lease Liability in a Sale and Leaseback. It summarises the considerations of the International Accounting Standards Board (Board) when developing the Exposure Draft. Individual Board members gave greater weight to some factors than to others.*

### **Background**

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- BC1 The IFRS Interpretations Committee (Committee) received a request about a sale and leaseback transaction that includes variable lease payments in which, applying paragraph 99 of IFRS 16 *Leases*, the transfer of the asset satisfies the requirements to be accounted for as a sale of the asset. The request asked how the seller-lessee measures the right-of-use asset arising from the leaseback and, thus, determines any gain or loss to recognise at the date of the transaction. The Committee concluded that the requirements in paragraph 100 of IFRS 16 provide an adequate basis for a seller-lessee to determine the accounting for the sale and leaseback transaction at the date of the transaction. The Committee, therefore, published an agenda decision in June 2020 explaining this conclusion.
- BC2 However, the Committee's discussions highlighted the improvements that could be made to IFRS 16 by adding subsequent measurement requirements for sale and leaseback transactions. The requirements that apply on initial recognition of a lease that is part of a sale and leaseback transaction differ from those that apply on initial recognition of a lease that is unrelated to such transactions. Therefore, the right-of-use asset and liability arising from a leaseback could be measured differently from the right-of-use asset and liability arising from a lease that is unrelated to sale and leaseback transactions. IFRS 16 includes no specific subsequent measurement requirements for sale and leaseback transactions. Consequently, it is not always clear how to subsequently measure the liability arising from a leaseback, in particular when the payments for the lease include payments that do not meet the definition of lease payments in IFRS 16.
- BC3 The Board was informed that diverse views on how to subsequently measure the liability arising in a sale and leaseback transaction could lead to material differences in the financial statements of seller-lessees that enter into such transactions. Sale and leaseback transactions often involve the sale of high-value items of property, plant and equipment with a long economic life; therefore, the accounting for such transactions can have a long-term material effect on the financial position of seller-lessees. It is, therefore, important for users of financial statements that seller-lessees apply the requirements in IFRS 16 consistently to sale and leaseback transactions, both on initial recognition and subsequently. Consequently, the Board proposes an amendment to IFRS 16 to enhance the initial measurement requirements 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 to add subsequent measurement requirements for that liability.

### **Proposed amendment to IFRS 16**

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- BC4 IFRS 9 *Financial Instruments* excludes from its scope ‘rights and obligations under leases to which IFRS 16 applies’. When the transfer of an asset in a sale and leaseback transaction satisfies the requirements in IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale, the Board considered whether the liability arising from the leaseback should be considered a lease liability to which IFRS 16 applies. The Board concluded that the liability should be considered a lease liability because:
- (a) a sale and leaseback transaction contains a lease as described in paragraph 9 of IFRS 16. The seller-lessee transfers an asset to the buyer-lessor in exchange for consideration received, and immediately obtains the right to control the use of the asset for a period of time in exchange for consideration payable.
  - (b) paragraph 100 of IFRS 16 specifies requirements for the measurement of the right-of-use asset arising from the leaseback. If the seller-lessee has the right to use the asset, then the seller-lessee’s obligation to make payments to the buyer-lessor over the lease term is a liability that relates to that right of use.
- BC5 This Exposure Draft, therefore, clarifies that the liability arising from the leaseback is a lease liability to which IFRS 16 applies. The Exposure Draft also proposes subsequent measurement requirements for the lease liability arising in a sale and leaseback transaction that are based on the requirements in paragraphs 36–38 of IFRS 16.
- BC6 When payments for the lease in a sale and leaseback transaction meet the definition of lease payments in IFRS 16, the Board expects seller-lessees to apply the subsequent measurement requirements in paragraphs 36–38 of IFRS 16 largely as they would when subsequently measuring other lease liabilities.
- BC7 However, paragraphs 36–38 of IFRS 16 specify subsequent measurement requirements for lease liabilities that only reflect payments that meet the definition of lease payments. Variable lease payments that do not depend on an index or rate (and that are not in-substance fixed payments) do not meet the definition of lease payments but would nonetheless be reflected in the initial measurement of the lease liability arising in a sale and leaseback transaction applying the requirements in paragraph 100(a) of IFRS 16 (see paragraph BC11). Consequently, the proposed amendment specifies subsequent measurement requirements that would apply to the lease liability arising in a sale and leaseback transaction.
- BC8 The proposed amendment applies to all sale and leaseback transactions but is expected to affect sale and leaseback transactions that include variable lease payments.

### Approach to developing measurement requirements for sale and leaseback transactions

- BC9 When developing the sale and leaseback requirements in IFRS 16, the Board considered whether to require seller-lessees to initially measure the right-of-use asset and lease liability arising from a leaseback in the same way as other right-of-use assets and lease liabilities. Such an approach would have resulted in seller-lessees recognising the full gain or loss on the sale of the asset. The Board rejected such an approach because, in the Board's view, recognising the full gain or loss on the sale would not have reflected the economics of a sale and leaseback transaction. Instead, paragraph 100(a) of IFRS 16 requires seller-lessees to:
- (a) measure the right-of-use asset arising from a leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee; and
  - (b) recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.
- BC10 Paragraph BC266 of IFRS 16 explains that although a seller-lessee may have transferred legal ownership of the asset to the buyer-lessor, by entering into a lease of that same asset for a period of time, the seller-lessee has not transferred all the rights embedded in legal ownership of the asset. That is, the seller-lessee has transferred only its interest in the value of the asset at the end of the leaseback and retained the right to use the asset for the period of the lease. Accordingly, the Board concluded that recognising only the amount of the gain or loss that relates to the rights transferred to the buyer-lessor—and thus not recognising the amount of the gain or loss that relates to the rights retained by the seller-lessee—appropriately reflects the economics of a sale and leaseback transaction.
- BC11 The initial measurement of the lease liability arising from a leaseback is then derived from how the right-of-use asset is measured—and the gain or loss determined—applying paragraph 100(a) of IFRS 16. As a consequence, the initial measurement of the lease liability typically reflects the value of the right of use retained by the seller-lessee. This means that, for a sale and leaseback transaction that includes variable lease payments, the initial measurement would typically reflect the expected lease payments at market rates. Those expected payments may include variable lease payments that do not meet the definition of lease payments in IFRS 16—for example, variable lease payments that do not depend on an index or rate, and future changes in payments resulting from changes in the reference index or rate for variable lease payments that depend on an index or rate.
- BC12 In developing the proposed amendment, the Board considered two ways to subsequently measure the lease liability arising in a sale and leaseback transaction—subsequently measure the lease liability:
- (a) consistently with its initial measurement, including all payments regardless of whether they meet the definition of lease payments (paragraph BC13); and

(b) in the same way as other lease liabilities, excluding payments that do not meet the definition of lease payments (paragraph BC14).

BC13 Consistent with its view of the economics of the transaction (as explained in paragraph BC10), the Board concluded that seller-lessees should subsequently measure the lease liability in a way that would prevent the recognition of a gain or loss on the right of use the seller-lessee retains via the leaseback. The Board, therefore, decided to propose subsequent measurement requirements for the lease liability that are consistent with its initial measurement and the Board's objective and rationale when it developed the sale and leaseback requirements in IFRS 16. This approach would require seller-lessees to include all payments in the measurement of the lease liability, thereby avoiding the recognition of an additional gain or loss associated with the sale of the asset when no transaction or event has occurred to give rise to such a gain or loss.

BC14 In contrast, subsequently measuring the lease liability arising from a leaseback in the same way as other lease liabilities could result in the seller-lessee recognising some or all of the gain or loss that relates to the right of use it retains via the leaseback. For example, applying such an approach to a sale and leaseback transaction that includes variable lease payments that do not depend on an index or rate, the seller-lessee would exclude those variable payments from the subsequent measurement of the lease liability and recognise a gain on remeasurement. The seller-lessee would recognise a gain, even though no transaction or event would have occurred to give rise to that gain.

BC15 The Board noted that its proposal regarding the measurement of lease liabilities arising in a sale and leaseback transaction would change neither the measurement requirements for other lease liabilities nor the basis for those requirements as explained in paragraphs BC163–BC169 of IFRS 16. The Board's proposal relates only to sale and leaseback transactions and is consistent with its rationale when developing the sale and leaseback requirements in IFRS 16. The Board concluded that it would be inappropriate to reconsider the sale and leaseback requirements in IFRS 16 more holistically at this time, in advance of the post-implementation review of the Standard.

### **Measurement requirements for sale and leaseback transactions**

BC16 As explained in paragraph BC9, paragraph 100(a) of IFRS 16 requires seller-lessees to measure the right-of-use asset arising from a leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. IFRS 16 does not, however, prescribe a method for determining that proportion and, consequently, does not prescribe a method for determining the initial measurement of the right-of-use asset and lease liability arising from a leaseback.

BC17 The Board concluded that requiring seller-lessees to determine the initial measurement of the right-of-use asset and lease liability arising from a leaseback using the present value of expected lease payments would be the most effective way to achieve its objective in prescribing subsequent

measurement requirements for the lease liability (see paragraph BC13). This is because such an approach would result in proposed requirements that are simpler and more understandable than would be the case applying any of the alternative approaches (see paragraphs BC22–BC26). This approach would also eliminate possible differences in the method seller-lessees use to initially measure the right-of-use asset and lease liability arising from a leaseback, facilitating greater consistency in accounting for sale and leaseback transactions.

- BC18 In reaching this decision, the Board acknowledged that, for a lease that is unrelated to sale and leaseback transactions, a lessee excludes from the measurement of the lease liability variable lease payments that do not depend on an index or rate (and that are not in-substance fixed payments). When developing IFRS 16, the Board had noted concerns about the high level of measurement uncertainty that would result from including such variable payments in the measurement of the lease liability and about the cost associated with such estimates because of the high volume of leases held by some lessees.
- BC19 However, for sale and leaseback transactions, the Board expects that seller-lessees would be able to reasonably estimate the expected lease payments because seller-lessees are in a different position from lessees that enter into a lease that is unrelated to sale and leaseback transactions. In particular:
- (a) a seller-lessee owns and controls the underlying asset until the sale and leaseback transaction. Seller-lessees should, therefore, have access to information that would enable them to reasonably estimate the fair value of the underlying asset and the expected lease payments. The Board also observed that seller-lessees would need to have that information to assess whether to enter into the transaction and the price at which to enter into it.
  - (b) applying the requirements in paragraph 101 of IFRS 16, seller-lessees are already required to consider whether the payments for the lease are at market rates and whether the fair value of the consideration equals the fair value of the underlying asset.
  - (c) seller-lessees generally do not have high volumes of sale and leaseback transactions that include variable lease payments.
- BC20 Consequently, this Exposure Draft proposes that:
- (a) when applying paragraph 100(a) of IFRS 16 to initially measure the right-of-use asset and lease liability, a seller-lessee would determine the proportion of the asset sold that relates to the right of use it retains by comparing the present value of the expected lease payments to the fair value of the asset sold.
  - (b) when subsequently measuring the lease liability, the seller-lessee would reduce the carrying amount to reflect the expected lease payments for the reporting period as determined at the commencement date—that is, the carrying amount would be reduced to reflect both the amount of those payments and when they were



expected to be paid as at the commencement date. The seller-lessee would generally recognise in profit or loss any difference between those expected lease payments and the actual payments made for the lease. Any shortfalls in the actual payments made (or recoveries of shortfalls) would be recognised as an adjustment to the carrying amount of the lease liability.

- BC21 This Exposure Draft also proposes to specify the payments that comprise the expected lease payments for sale and leaseback transactions. The Board's use of the term 'expected' is consistent with other uses of the term in IFRS 16 and, for example, does not consider expected credit risk.

#### **Alternative approaches considered**

- BC22 The Board considered but rejected two alternative approaches that would achieve its objective for subsequent measurement of the lease liability arising from a leaseback (see paragraph BC13) but would have been more difficult to understand and apply consistently than the proposed approach. Both of these approaches would have proposed requirements related only to subsequent measurement of the lease liability arising from a leaseback, and thus would not have proposed to prescribe the method used to determine the initial measurement of the right-of-use asset and lease liability. Those approaches are:

- (a) the imputed lease payments approach (paragraph BC24); and
- (b) the imputed discount rate approach (paragraph BC25).

- BC23 To illustrate these approaches with an example, assume a seller-lessee sells an asset and leases it back for five years with annual lease payments of CU100,000. The seller-lessee determines the initial measurement of the right-of-use asset and lease liability arising from the leaseback by comparing the fair value of the right of use retained to the fair value of the asset sold. Applying the existing requirements in paragraph 100(a) of IFRS 16, the seller-lessee initially measures the lease liability at CU450,000. The seller-lessee's incremental borrowing rate is 3.2% (the interest rate implicit in the lease cannot be readily determined).

- BC24 When subsequently measuring the lease liability, the imputed lease payments approach would have required a seller-lessee to impute the lease payments included in the measurement of the lease liability. These imputed payments would be determined as those that, when discounted using the discount rate in paragraph 37 of IFRS 16 (that is, the interest rate implicit in the lease—if that can be readily determined—or the seller-lessee's incremental borrowing rate), result in the carrying amount of the lease liability on initial recognition. In the example set out in paragraph BC23, the seller-lessee would have imputed the lease payments included in the initial measurement of the lease liability as an annual lease payment of CU98,821—CU98,821 is the annual payment that, when discounted at 3.2% (the seller-lessee's incremental borrowing rate) results in CU450,000 (the carrying amount of the lease liability on initial recognition).

- BC25 In contrast, the imputed discount rate approach would have required a seller-lessee to (a) consider the expected lease payments as the lease payments included in the initial measurement of the lease liability; and then (b) impute the discount rate as that which would result in the carrying amount of the lease liability on initial recognition. That is, rather than using the discount rate in paragraph 37 of IFRS 16, the seller-lessee would have been required to impute the discount rate that, when applied to the expected lease payments, results in the carrying amount of the lease liability on initial recognition. In the example set out in paragraph BC23, the seller-lessee would have imputed a discount rate of 3.62% to use when subsequently measuring the lease liability – 3.62% is the rate that, when applied to the expected annual lease payments of CU100,000 results in CU450,000 (the carrying amount of the lease liability on initial recognition).
- BC26 The Board rejected both approaches because they would have been difficult to understand and apply consistently. In particular:
- (a) with an imputed lease payments approach, the lease payments that a seller-lessee imputes could differ from the expected contractual lease payments, if the seller-lessee initially measures the right-of-use asset and lease liability using a method other than the present value of the expected lease payments. The Board concluded that such an outcome would complicate the proposals, especially when applied to sale and leaseback transactions with fixed payments. For example, in the example in paragraph BC24, the imputed lease payments would be CU98,821 whereas the contractual lease payments are CU100,000 – this difference would have been treated as a variable lease payment.
  - (b) with an imputed discount rate approach, the discount rate that would be imputed could be different from both the interest rate implicit in the lease and the seller-lessee's incremental borrowing rate. For example, in the example in paragraph BC25, the imputed discount rate would be 3.62% whereas the seller-lessee's incremental borrowing rate is 3.2%.

### **Reassessments or lease modifications related to a sale and leaseback transaction**

- BC27 If there is a change in the lease term, or the lease is modified and the seller-lessee does not account for the modification as a separate lease, paragraphs 40(a) and 45 of IFRS 16 require the lessee to remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The Board observed that, in a sale and leaseback transaction that includes variable lease payments, a change in the lease term or a lease modification could result in remeasuring the lease liability on a basis different from its initial measurement – for example, excluding variable lease payments that do not depend on an index or rate. For the reasons described in paragraph BC10, the Board concluded that such an outcome would not reflect the economics of a sale and leaseback transaction and would be inconsistent with the initial measurement, and proposed approach to subsequent measurement, of the lease liability arising in that transaction.

- BC28 For example, in a sale and leaseback transaction that includes variable lease payments linked to future performance of the asset, assume the lease is modified to change only the calculation of the payments for the lease. That is, before and after the modification, the payments for the lease are variable lease payments linked to future performance of the asset. Without any clarification of the application of paragraph 45 of IFRS 16, the seller-lessee in this situation might remeasure the lease liability to exclude those variable lease payments because they do not meet the definition of lease payments, resulting in the recognition of a gain relating to the right of use retained by the seller-lessee.
- BC29 Consequently, this Exposure Draft proposes that, in remeasuring the lease liability to reflect a change in the lease term or a lease modification related to a sale and leaseback transaction, the revised lease payments (as described in paragraphs 40(a) and 45 of IFRS 16) would be the revised expected lease payments at the date of remeasurement. This proposal would result in subsequently measuring the lease liability on the same basis as its initial measurement in these circumstances.
- BC30 Other than for changes in the lease term or lease modifications, in the Board's view there would be no significant benefit in requiring seller-lessees to remeasure the lease liability if the seller-lessee's expectations of future variable lease payments were to change. IFRS 16 already includes various simplifications to the measurement of lease liabilities for variable lease payments that arise from a lease that is unrelated to sale and leaseback transactions. Consequently, this Exposure Draft proposes that a seller-lessee does not remeasure the lease liability to reflect a change in future variable lease payments related to a sale and leaseback transaction, other than as specified for changes in the lease term or lease modifications.

### Example

- BC31 The Board concluded that developing an example with journal entries would enhance the understandability of the proposed amendment. This Exposure Draft, therefore, proposes to add an example to the illustrative examples accompanying IFRS 16 to illustrate how a seller-lessee accounts for a sale and leaseback transaction that includes variable lease payments.

### Transition

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- BC32 The Board concluded that the expected benefits of retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would outweigh the costs. This is because:
- (a) sale and leaseback transactions often involve the sale of high-value items of property, plant and equipment with a long economic life. The accounting for such transactions could have a long-term material effect on the financial position of seller-lessees. It is, therefore, important for users of financial statements that seller-lessees apply IFRS 16 consistently to those transactions.

- (b) although the proposed amendment applies to all sale and leaseback transactions occurring after the initial application of IFRS 16, it is expected to affect those that include variable lease payments. Therefore, for most seller-lessees, the proposed amendment would affect only sale and leaseback transactions occurring from 2019 that include variable lease payments.

BC33 Retrospective application of the proposed amendment might involve the use of hindsight for sale and leaseback transactions that include variable lease payments and for which the seller-lessee has not already applied accounting consistent with that in the proposed amendment. This is because retrospective application would require the seller-lessee to estimate the expected lease payments at the commencement date of the sale and leaseback transaction.

BC34 The Board expects circumstances that might involve the use of hindsight to be rare because many sale and leaseback transactions are likely to include only fixed payments. Nonetheless, the Board proposes specific transition requirements in paragraph C20E to avoid the use of hindsight and to ensure seller-lessees apply the same approach if those circumstances arise.

**Alternative view of Ms Françoise Flores on Exposure Draft *Lease Liability in a Sale and Leaseback***

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- AV1 Ms Flores agrees the Board should propose an amendment to IFRS 16 to the extent that amendment would apply to circumstances in which lease payments (as defined in paragraph 27 of IFRS 16) exist. In circumstances in which payments for the right to use an asset are variable payments linked to future performance, Ms Flores disagrees with the Board's starting point in the analysis and, as a consequence, with the Board's conclusions as summarised in paragraphs BC11–BC15 of the Exposure Draft.
- AV2 Ms Flores believes that the matter should be re-examined, starting with the request initially submitted to the IFRS Interpretations Committee. The analysis should acknowledge as a first step—and not merely mention, as in paragraph BC11, that the Board's analysis contradicts the definition of lease payments in IFRS 16—that IFRS 16 includes an implicit conflict between its sale and leaseback requirements and its definition of lease payments and related lease liability. To be resolved, in Ms Flores' view, this implicit conflict requires standard-setting that encompasses initial recognition. Ms Flores believes a full discussion is needed of what principle should prevail at initial recognition of a sale and leaseback transaction that includes variable payments with regard to the economics of the transaction, to the Board's views expressed in paragraph BC169 of IFRS 16 (high level of measurement uncertainty and whether a liability exists) and to the sale and leaseback requirements being an exception to the basic model. In Ms Flores' view, such an analysis is currently lacking.
- AV3 In contrast with the Board's explanation in paragraph BC266 of IFRS 16 (which forms the basis of the proposed amendment), a seller-lessee no longer has the *same* right to use the asset for the lease term as it had before the transaction—it now has to share benefits with the buyer-lessor. The seller-lessee no longer bears demand risk for the asset and consequently is not exposed to any cash outflow until and to the extent the asset performs, which is different from the economic exposure of other seller-lessees. In Ms Flores' view, such a significant change in the seller-lessee's economic circumstances brings discontinuity that can justify full derecognition of the asset sold and recognition of any related gain in full.
- AV4 Further, Ms Flores believes that the Board made the right decision to exclude variable payments linked to future performance from the definition of lease payments. She agrees with the reasons explained in paragraph BC169 of IFRS 16, among which no liability exists at the commencement date (the lease liability arises with performance) and a high level of measurement uncertainty would arise in estimating expected payments. Ms Flores notes that, in the circumstances that have arisen during the covid-19 pandemic, seller-lessees exposed only to payments linked to future performance would, in accordance with the accounting proposed in the Exposure Draft, record a gain if their activities cease. In Ms Flores' view, such a gain would be an unfair reflection of their economic performance. She also points out that, in her view, the proposal in the Exposure Draft would lead to a high level of

measurement uncertainty that the Board considered best avoided when developing IFRS 16.



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