STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Sale and leaseback with variable payments (IFRS 16)**
Paper topic	Initial Consideration

CONTACT(S) Satenik Vanyan svanyan@ifrs.org +44 (0)20 7246 6918

Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about a sale and leaseback transaction with variable payments. Specifically, the submitter asks how, applying IFRS 16 *Leases*, the seller-lessee measures the right-of-use asset arising from the leaseback, and thus determines any gain or loss recognised at the date of the transaction.

2. The objective of the paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes the following:

   (a) background information;

   (b) outreach;

   (c) staff analysis; and

   (d) staff recommendation.

4. There are three appendices to this paper:

   (a) Appendix A—proposed wording of the tentative agenda decision;

   (b) Appendix B—Illustrative Example 24 accompanying IFRS 16; and

   (c) Appendix C—submission.

Background information

The transaction

5. The submission outlines the following transaction:

   (a) An entity (seller-lessee) enters into a sale and leaseback transaction whereby it transfers an item of property, plant and equipment (the asset) to another entity (buyer-lessor) and leases the asset back for 10 years.

   (b) The transfer of the asset satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale of the asset.

   (c) The amount paid by the buyer-lessor to the seller-lessee in exchange for the asset (i) equals the asset's fair value; and (ii) is more than the carrying amount of the asset in the seller-lessee's financial statements at the date of the transaction.

   (d) All payments for the lease (which are at market rates) are variable, calculated as a percentage of the seller-lessee's revenue generated using the asset during the 10-year lease term. The seller-lessee has determined that the payments are not in-substance fixed payments as described in IFRS 16.

The question and illustration

6. The submitter asks how the seller-lessee measures the right-of-use (ROU) asset arising from the leaseback, and thus determines the amount of the gain that it recognises at the date of the transaction. The submission identifies two ways of measuring the ROU asset (and consequently the gain recognised)—see Appendix C to this paper.

7. To illustrate, consider the following example (included in the submission):

> Seller-lessee enters into a sale and leaseback transaction whereby it transfers an asset to Buyer-lessor, and leases that asset back for 10 years. The carrying amount of the asset in Seller-lessee's financial statements at the date of the transaction is CU1,000,000, and the amount paid by Buyer-lessor for the asset is CU1,800,000 (the fair value of the asset). All the leaseback payments (which are at market rates) are variable, calculated as a percentage of Seller-lessee's revenue generated using the asset during the 10-year lease term. At the date of the transaction, the present value of the expected leaseback payments is CU450,000. There are no initial direct costs.

8. Paragraph 100(a) of IFRS 16 requires the seller-lessee to 'measure the ROU 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'.

9. The submitter asks whether, in applying paragraph 100(a):

    (a) Seller-lessee takes into account the requirements in paragraph 24 of IFRS 16[1] when it measures the ROU asset. If Seller-lessee takes those requirements into account (and because all leaseback payments are variable and not based on an index or rate), then it would measure the ROU asset at zero because the lease liability would be zero applying paragraph 27 of IFRS 16[2]. Consequently, Seller-lessee would recognise a gain of CU800,000 [CU1,800,000 *cash received from Buyer-lessor* – CU1,000,000 *carrying amount of the asset immediately before the transaction*], reflecting the total gain on sale of the asset.

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[1] Paragraph 24 of IFRS 16 specifies that the cost of the ROU asset comprises (a) the amount of the initial measurement of the lease liability; (b) any lease payments made at or before the commencement date; (c) any initial direct costs; and (d) an estimate of decommissioning costs.

[2] Paragraph 27 of IFRS 16 specifies that the lease payments included in the measurement of the lease liability comprise (a) fixed payments (including in-substance fixed payments); (b) variable lease payments that depend on an index or rate; (c) amounts expected to be payable under residual value guarantees; (d) the exercise price of a purchase option if reasonably certain to be exercised; and (d) payments of penalties for terminating the lease if such termination is reflected in the lease term.

(b) Seller-lessee measures the ROU asset as a proportion of the asset's previous carrying amount to reflect the right of use retained by Seller-lessee. To calculate the proportion, Seller-lessee determines a value for the right of use retained—calculated, for example, as the present value of the expected leaseback payments (at market rates) of CU450,000. Using this calculation, Seller-lessee would measure the ROU asset at CU250,000, calculated as:

$$\underset{\textit{(previous carrying amount of the asset)}}{\text{CU1,000,000}} \times \frac{\underset{\textit{(present value of expected leaseback payments)}}{\text{CU450,000}}}{\underset{\textit{(fair value of the asset)}}{\text{CU1,800,000}}}$$

In that case, Seller-lessee recognises a gain of CU600,000 at the date of the transaction, which is the gain that relates to the rights transferred to Buyer-lessor. The gain is calculated as:

$$\underset{\textit{(total gain on sale of the asset)}}{\text{CU800,000}} \times \frac{\underset{\textit{(value of the rights transferred to the buyer-lessor)}}{\text{CU1,800,000 - CU450,000}}}{\underset{\textit{(fair value of the asset)}}{\text{CU1,800,000}}}$$

Outreach

10. We sent an information request to members of the International Forum of Accounting Standard-Setters, securities regulators and large accounting firms. The submission was also made available on our website.

11. The request asked those participating to provide information based on their experience about:

    (a) whether the transaction is common in their jurisdiction and, if so, for which industries or for what types of assets; and

    (b) how the seller-lessee typically measures the ROU asset and, thus, determines the amount of any gain or loss recognised at the date of the transaction.

12. We received 14 responses—five from large accounting firms, eight from national standard-setters and one from an organisation representing groups of securities

regulators. The views received represent informal opinions, rather than formal views of those responding.

Prevalence

13. Four respondents say the transaction described in the submission is not common.

14. Some respondents say the transaction, or similar transactions, is (or might become) common in the retail industry where some or all leaseback payments can be based on the seller-lessee's revenue. Respondents also mention energy production facilities where some or all leaseback payments might be based on the electricity produced, and also bearer plants in the agriculture industry.

15. Several respondents mention Canada as a jurisdiction where these types of transactions are common. Others mention Switzerland, the United States, Singapore, China and Japan.

16. Several respondents say they expect this type of sale and leaseback transaction to become more common.

Accounting treatment expected to be applied

17. Some respondents say, because this is the first year of application of IFRS 16, the information provided in their response is based on their understanding of how entities intend to account for such sale and leaseback transactions, rather than on observed practice. Respondents mention the following approaches, which are similar to those identified in the submission (see Appendix C) and in paragraph 9 of this paper.

ROU asset measured taking into account paragraph 24 of IFRS 16

18. Some say the seller-lessee would measure the ROU asset arising from the leaseback transaction taking into account the requirements in paragraph 24 of IFRS 16. This means that the seller-lessee would measure the ROU asset at zero (see explanation above in paragraph 9(a)). Consequently, respondents say, on transfer of the asset to the buyer-lessor, the seller-lessee would recognise the total gain on sale of the asset in profit or loss. One respondent suggests, applying this approach, the seller-lessee

recognises in profit or loss only the portion of the gain relating to the rights transferred.

ROU asset measured as a proportion of the previous carrying amount

19. Others say the seller-lessee would measure the ROU asset arising from the leaseback transaction as a proportion of the asset's previous carrying amount applying paragraph 100(a) of IFRS 16. The seller-lessee would determine the proportion using a method that reflects the right of use retained by the seller-lessee. Some methods suggested include the use of the present value of (a) leaseback payments (at market rates) compared to the fair value of the asset, and (b) the residual value of the asset at the end of the lease term compared to its fair value at the date of the transaction.

Staff analysis

When does the question arise?

20. The question in the submission arises for sale and leaseback transactions for which some or all leaseback payments are variable, and ordinarily would *not* be included in the lease liability if paragraph 27 of IFRS 16 were to be applied. If leaseback payments (at market rates) were fixed, in-substance fixed or variable depending on an index or rate, we would generally expect little difference in the outcome from applying the two approaches described in paragraph 9 of this paper.

21. To illustrate the question, the submitter sets out a simplified example (described in paragraph 7)—the transaction is one in which the buyer-lessor pays the seller-lessee the fair value of the asset at the date of the transaction and all leaseback payments over a 10-year period are variable, calculated as a percentage of the seller-lessee's future revenue. In such a case, the buyer-lessor has agreed to take on very significant risks. It has agreed to pay the seller-lessee the full market value of the asset at the date of the transaction and yet expose itself to variability in returns—and at the extreme the possibility of no returns—from that investment in the asset for a 10-year period. For this reason, we would expect very few sale and leaseback transactions that involve the buyer-lessor (a) paying the fair value of the asset to the seller-lessee at

the date of the transaction; and yet (b) agreeing to receive leaseback payments that are wholly variable[3].

22. What is more likely to occur is that the buyer-lessor may agree either:

    (a) to pay a below-market price for the asset at the date of the transaction, and then receive leaseback payments that are lower than market rates[4]; or

    (b) to receive leaseback payments (that are market rates), which are partially or wholly fixed.

23. Given the risks involved for the buyer-lessor if it were to agree to variable leaseback payments, it is important to consider whether leaseback payments are not in fact variable but, rather, are in-substance fixed payments. Paragraph B42 of IFRS 16 states that 'in-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable'. For the purpose of the submission, we have assumed that the leaseback payments are indeed variable.

24. Although we would expect the transaction described in the submission to be rare, we note that the question asked could also arise when a *portion* of the leaseback payments are variable. Outreach responses also note respondents' expectations that such sale and leaseback transactions may occur more frequently in the future. We have therefore analysed the question submitted in the following paragraphs.

What does IFRS 16 say?

25. Paragraphs 98-103 of IFRS 16 specify requirements for sale and leaseback transactions. Paragraph 98 states:

> If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease applying paragraphs 99-103.

[3] Such a transaction possibly could occur for some energy production facilities for which the risk with respect to the amount of electricity generated is perceived to be low.

[4] This scenario is not the subject of the submission, and thus this paper does not discuss it further. We note that IFRS 16 addresses the scenario in paragraph 101.

26. When 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, paragraphs 100-102 apply to the sale and leaseback transaction. Paragraph 100(a) addresses the measurement of the ROU asset arising from the leaseback and, consequently, the amount of any gain or loss recognised by the seller-lessee. Paragraph 100 states (**emphasis** added):

> 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 recognise **only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor**…

27. Paragraph BC266 explains the rationale for the Board's decisions in developing the requirements in paragraph 100(a):

> The IASB decided that the gain or loss recognised by a seller-lessee on a completed sale in a sale and leaseback transaction should reflect the amount that relates to the rights transferred to the buyer-lessor. In reaching this decision, the IASB considered requiring the sale element of the transaction (ie the sale of the underlying asset) to be accounted for applying IFRS 15 because, from a legal standpoint, the seller-lessee will often have sold the entire underlying asset to the buyer-lessor. However, from an economic standpoint, the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback—it has retained its right to use the asset for the duration of the leaseback. The seller-lessee had already obtained that right to use the asset at the time that it purchased the asset—the right of use is an embedded part of the rights that an entity obtains when it purchases, for example, an item of property, plant and equipment. Accordingly, in the IASB's view, recognising the gain that relates to the rights transferred to the

buyer-lessor appropriately reflects the economics of the transaction.

28. Illustrative Example 24 accompanying IFRS 16 (reproduced in Appendix B) illustrates the requirements in paragraphs 99-102 for both the seller-lessee and the buyer-lessor. The transaction in that example is not the same as the transaction in the submission, in that (a) it illustrates the accounting when the transaction includes above-market terms; and (b) all leaseback payments are fixed (rather than variable). Nonetheless, the example illustrates the following that are relevant to the transaction described in the submission:

    (a) the seller-lessee measures the ROU asset at the proportion of the asset's previous carrying amount that relates to the right of use retained by the seller-lessee. The value of the right of use retained is calculated as the present value of the expected leaseback payments (at market rates).

    (b) the seller-lessee recognises the gain that relates to the rights transferred to the buyer-lessor. The seller-lessee determines the value of the rights transferred to the buyer-lessor by deducting the value of the right of use retained (calculated as in (a) above) from the fair value of the asset.

29. As explained in paragraph BC266 (reproduced above in paragraph 27), the Board developed the requirements for sale and leaseback transactions to reflect the economics of the transaction—ie although the 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, in fact, transferred all the rights embedded in legal ownership of the asset. It has transferred only its interest in the value of the asset at the end of the leaseback and *retained* its right to use the asset for the period of the lease. That right of use is not a newly-acquired right at the time of the sale and leaseback transaction—the seller-lessee obtained that right of use when it purchased the asset. Accordingly, the seller-lessee does not remeasure the right of use retained—the ROU asset arising from the leaseback is measured as a proportion of the asset's previous carrying amount—and, consequently, the seller-lessee recognises only the amount of the gain that relates to the rights transferred to the buyer-lessor.

Application of IFRS 16 to the transaction submitted

30. Paragraphs 100-102 of IFRS 16 apply to the transaction described in the submission. This is because the transaction is one in which:

    (a) the seller-lessee transfers an asset to the buyer-lessor and leases that asset back from the buyer-lessor. For such transactions, paragraph 98 requires the seller-lessee to account for both the transfer contract and the lease applying paragraphs 99-103.

    (b) the transfer of the asset satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset. Paragraphs 100-102 include requirements that specifically apply to such a sale and leaseback transaction.

31. Consequently, the seller-lessee applies paragraph 100(a) to the transaction described in the submission in measuring the ROU asset arising from the leaseback and in determining the amount of the gain to be recognised at the date of the transaction.

Measurement of the ROU asset

32. Applying paragraph 100(a), the seller-lessee measures the ROU asset 'at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee'. That measurement requires the seller-lessee to determine the proportion of the asset transferred to the buyer-lessor that relates to the right of use retained—in our view, this requires a comparison of the value of the right of use retained via the leaseback to the value of the asset transferred to the buyer-lessor.

33. IFRS 16 does not prescribe a particular method for calculating that proportion. The Board's explanation in paragraph BC266 (see paragraph 27 above) is helpful in assessing what would be an appropriate and reasonable method to use. Paragraph BC266 explains that, in a sale and leaseback transaction, the seller-lessee economically has transferred its interest in the value of the asset at the end of the leaseback, and has retained the right to use the asset for the period of the leaseback. Accordingly, the seller-lessee uses a calculation method that, economically, splits the value of the asset (as a whole) at the date of the transaction into:

(a) a value for the right of use that it has retained via the leaseback (for example, the present value of expected leaseback payments at market rates); and

(b) a value for the rights transferred to the buyer-lessor (for example, the present value of the expected residual value of the asset at the end of the leaseback).

34. In accounting for a sale and leaseback transaction (that satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset), the seller-lessee will know the fair value of the asset transferred—this is because paragraph 101 of IFRS 16 requires the seller-lessee to make adjustments to measure the sale proceeds at fair value if the transaction includes above or below-market terms. Therefore, the seller-lessee could calculate the proportion of the asset's previous carrying amount that relates to the right of use retained using either (a) the value of the right of use retained, or (b) the value of the rights transferred to the buyer-lessor, and comparing that value to the fair value of the asset at the date of the transaction.

35. In the example described in paragraph 7 and 9(b) of this paper (and also in Illustrative Example 24), the seller-lessee determines a value for the right of use retained using the present value of the expected leaseback payments at market rates. The seller-lessee then measures the ROU asset arising from the leaseback using the following calculation:

$$\textit{Previous carrying amount of the asset} \times \frac{\textit{Value of right of use retained}}{\textit{Fair value of the asset}}$$

36. Accordingly, in the example described in paragraph 7, the seller-lessee measures the ROU asset at CU250,000, calculated as:

$$\underset{\text{(}\textit{previous carrying amount of the asset}\text{)}}{\text{CU1,000,000}} \times \frac{\underset{\text{(}\textit{value of right of use retained}\text{)}}{\text{CU450,000}}}{\underset{\text{(}\textit{fair value of the asset}\text{)}}{\text{CU1,800,000}}}$$

Gain on rights transferred to the buyer-lessor

37. Paragraph 100(a) of IFRS 16 also specifies the amount of the gain or loss that the seller-lessee recognises at the date of the transaction, which is a consequence of how

the ROU asset is measured. As mentioned in paragraph 29 of this paper, the right of use is not a newly-acquired right at the time of the sale and leaseback transaction—the seller-lessee obtained that right of use when it purchased the asset. Therefore, the measurement of the right of use retained by the seller-lessee is, in effect, unchanged by the transaction because it is measured as a proportion of the previous carrying amount—as a consequence, there is no gain or loss to recognise relating to that right of use retained. Paragraph 100(a) states 'accordingly, the seller-lessee shall recognise only the amount of the gain or loss that relates to the rights transferred to the buyer-lessor'.

38. Again, IFRS 16 does not prescribe a particular method for calculating the gain or loss that relates to the rights transferred to the buyer-lessor. However, the seller-lessee would use the same basis as used in measuring the ROU asset—ie in measuring the ROU asset, the seller-lessee splits the fair value of the asset into the proportion that relates to the right of use retained and the proportion that relates to the rights transferred to the buyer-lessor (as mentioned in paragraph 32 of this paper). The seller-lessee would then use the calculation used in measuring the ROU asset to determine the gain that relates to the rights transferred to the buyer-lessor as follows:

$$\textit{Total gain on sale of the asset} \times \frac{\textit{Value of rights transferred to the buyer-lessor}}{\textit{Fair value of the asset}}$$

39. In the example described in paragraph 7, the seller-lessee recognises a gain of CU600,000, calculated as:

$$\underset{(\textit{total gain on sale of the asset})}{\text{CU800,000}} \times \frac{\underset{(\textit{value of the rights transferred to the buyer-lessor})}{\text{CU1,800,000 - CU450,000}}}{\underset{(\textit{fair value of the asset})}{\text{CU1,800,000}}}$$

40. Using that example, the seller-lessee recognises the following at the date of the transaction:

DR. Cash	1,800,000	
DR. ROU asset	250,000	
CR. Asset		1,000,000
CR. Financial liability		450,000
CR. Gain on rights transferred		600,000

In the transaction described in the submission, is it possible to measure the ROU asset at zero applying IFRS 16?

41. As noted above, the applicable requirements for the transaction described in the submission are in paragraph 100(a) of IFRS 16, which states: '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'.

42. Some might suggest that one way to comply with that requirement would be to refer to the measurement requirements in paragraph 24 of IFRS 16. For the transaction described in the submission, this would result in measuring the ROU asset at zero at the date of the transaction. If a lessee were to enter into a lease with exactly the same terms and conditions as the leaseback leg of the transaction described in the submission, the lessee would recognise a ROU asset of zero at the commencement date. Accordingly, some might suggest that this is an appropriate basis on which to measure the ROU asset arising from the leaseback in the transaction submitted.

43. In our view, the seller-lessee would not comply with the requirements in paragraph 100(a) of IFRS 16 if it were to measure the ROU asset at zero (unless the carrying amount of the asset immediately before the transaction is zero, which is not the transaction submitted). That is because zero would not represent 'the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee'.

44. In the example in paragraph 7 of this paper, the asset's previous carrying amount is CU1,000,000. Embedded within that asset (that the seller-lessee legally owned before

the transaction) are several rights, such as the right to use the asset for its remaining economic life, the right to pledge the asset and the right to sell the asset. The carrying amount of the asset immediately before the sale and leaseback transaction relates to all those rights, and therefore a proportion of that previous carrying amount relates to the right of use retained by the seller-lease. Consequently, to comply with paragraph 100(a), the seller-lessee must allocate a proportion of CU1,000,000 to the right of use it retains as a result of leaseback.

45. Similarly, the fair value of the asset of CU1,800,000 at the date of the transaction represents a market participant's view of the economic benefits that it will be able to generate from the asset over its remaining economic life. That includes the expected economic benefits during the leaseback period. The leaseback (conveying the right to use the asset for 10 years) has value—the buyer-lessor has not given the seller-lessee that right for free; it has charged a market rate for the 10-year right of use, the payments for which are calculated as a percentage of the seller-lessee's future revenue. The value of that right of use is determined to be CU450,000 at the date of the transaction—this means that of the fair value of the asset of CU1,800,000, CU450,000 relates to the right of use retained by the seller-lessee and CU1,350,000 relates to the rights transferred to the buyer-lessor. Measuring the ROU asset at zero would imply that the right to use the asset for 10 years has no value, which is untrue.

Staff conclusion

46. In the sale and leaseback transaction described in the submission, the seller-lessee applies paragraph 100(a) of IFRS 16. Therefore, at the date of the transaction, it:

    (a) measures the ROU 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; and accordingly

    (b) recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

47. To measure the ROU asset, the seller-lessee is required to determine the proportion of the asset transferred to the buyer-lessor that relates to the right of use retained—it

does so by comparing, at the date of the transaction, the value of the right of use it retains to the value of the asset transferred to the buyer-lessor.

48. The seller-lessee could determine the value of the right of use retained with reference to the expected residual value of the asset at the end of the leaseback, or with reference to the leaseback payments at market rates—for example, calculated as the present value of expected leaseback payments at market rates.

49. Applying paragraph 100(a), the measurement of the ROU asset cannot be zero in the transaction described in the submission. Consequently, we conclude that if determining the value of the right of use retained with reference to the leaseback payments, the seller-lessee calculates the value with reference to *all* leaseback payments at market rates; it would be inappropriate to determine the value of the right of use retained with reference to only some (or none) of those leaseback payments.

Question 1 for the Committee

1. Does the Committee agree with our analysis of the application of the requirements in IFRS 16 to the transaction described in the submission, summarised in paragraphs 46-49 of this paper?

Should the Committee add this matter to its standard-setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[5]

50. Based on our analysis, we think the requirements in IFRS 16 provide an adequate basis for an entity to determine its accounting for sale and leaseback transactions with variable payments.

Staff recommendation

51. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 50 of this paper), we

[5] Paragraph 5.16(b) of the *Due Process Handbook*

recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing a tentative agenda decision that outlines how an entity measures the ROU asset, and consequently determines the gain or loss recognised, at the date of a sale and leaseback transaction.

52. Appendix A to this paper sets out the proposed wording of the tentative agenda decision. The proposed wording describing the transaction has been drafted so that the agenda decision would apply to sale and leaseback transactions with some or all leaseback payments that are variable. This is because the question in the submission could arise for all such sale and leaseback transactions.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda?
3. Does the Committee have any comments on the proposed wording of the tentative agenda decision in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Sale and leaseback with variable payments (IFRS 16 *Leases*)

The Committee received a request about a sale and leaseback transaction with variable payments. In the transaction described in the request:

a. an entity (seller-lessee) enters into a sale and leaseback transaction whereby it transfers an item of property, plant and equipment (the asset) to another entity (buyer-lessor) and leases the asset back for 10 years.

b. the transfer of the asset satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale of the asset.

c. the amount paid by the buyer-lessor to the seller-lessee in exchange for the asset equals the asset's fair value at the date of the transaction.

d. payments for the lease (which are at market rates) include variable payments, calculated as a percentage of the seller-lessee's revenue generated using the asset during the 10-year lease term. The seller-lessee has determined that the variable payments are not in-substance fixed payments as described in IFRS 16.

The submitter asked how, in the transaction described in the request, the seller-lessee measures the right-of-use asset arising from the leaseback, and thus determines the amount of any gain or loss recognised at the date of the transaction.

The Committee observed that the requirements applicable to the transaction described in the request are in paragraph 100(a) of IFRS 16. Paragraph 100(a) states that '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 recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor'.

Consequently, to measure the right-of-use asset arising from the leaseback, the seller-lessee determines the proportion of the asset transferred to the buyer-lessor that relates to the right of use retained—it does so by comparing, at the date of the transaction, the value of the right of use it retains via the leaseback to the value of the asset transferred to the buyer-lessor. IFRS 16 does not prescribe a particular method to use in determining the value of the right of use retained by the seller-lessee. The seller-lessee could determine that value, for example, as the present value of expected leaseback payments (including those that are variable) at market rates.

The gain or loss recognised by the seller-lessee at the date of the transaction is a consequence of its measurement of the right-of-use asset arising from the leaseback. Because the right of use retained by the seller-lessee is not remeasured as a result of the transaction (ie it is measured as a proportion of the asset's previous carrying amount), the amount of the gain or loss recognised relates only to the rights transferred to the buyer-lessor.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine its accounting for a sale and leaseback transaction with variable payments. Consequently, the Committee [decided] not to add the matter to its standard-setting agenda.

Appendix B—Illustrative Example 24 accompanying IFRS 16

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. 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 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 annum) 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.

<u>Seller-lessee</u>

At the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building 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. This is calculated as: CU1,000,000 (the carrying amount of the building) ÷ CU1,800,000 (the fair value of the building) × CU1,259,200 (the discounted lease payments for the 18-year right-of-use asset).

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 ÷ CU1,800,000 × CU1,259,200) relates to the right to use the building retained by Seller-lessee; and

(b) CU240,355 (CU800,000 ÷ CU1,800,000 × (CU1,800,000 – CU1,259,200)) relates to the rights transferred to Buyer-lessor.

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
Financial liability		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 annum)	
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.

Appendix C—Submission

We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

The issue:

Application of IFRS 16 to sale and leaseback transactions.

Scenario:

An entity enters into a sale and leaseback transaction of freehold land (the underlying asset) whereby the entity leases back the asset for 10 years. The carrying amount of the underlying asset is CU1,000,000 and the sale consideration is CU1,800,000. The transfer of the asset by the seller-lessee satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale of the asset, and all the payments to be made under the leaseback are variable based on a percentage of the entity's revenue generated using, amongst others, the asset (and hence, they are not based on an index or rate), with no minimum amount. In addition, the consideration for the sale of the asset equals its fair value and the payments for the lease are at market rates. Assume the market rentals of the leaseback are expected to be CU450,000.

Paragraph 100(a) of IFRS 16 states that:

"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 lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor."

Question:

When the lease payments relating to the leaseback are totally variable and not based on an index or rate, how is the "proportion of the previous carrying amount of the asset that relates to the right-of-use retained by the lessee" determined? This affects the measurement of the gain recognised by the seller-lessee at the lease commencement date.

Current practice:

We have identified three potential accounting treatments for such a fact pattern.

View A: A right-of-use asset is not recognised

Proponents of View A believe that the right-of-use (ROU) asset arising from the leaseback should be subject to the measurement guidance for ROU assets in IFRS 16.24 in addition to IFRS 16.100(a). This means that the ROU asset arising from the leaseback in accordance with IFRS 16.100(a) should only include those items specified in IFRS 16.24. IFRS 16.24(a) states that the cost of the ROU asset comprises the lease liability. In this case, the lease payments are fully variable based on revenue generated (i.e., not based on an index or rate); and, thus, are not covered by any of the items under IFRS 16.27 (a) to (e) in measuring the lease liability. IFRS 16.24 (b) to (d) are not relevant in this case. As such, it is appropriate to conclude that the ROU asset arising from the leaseback should be nil and this means that there is no right-of-use retained.

Applying IFRS 16.100(a), the seller-lessee recognises the full gain of CU800,000 (being the difference between the consideration from the sale and the previous carrying amount of the asset).

This view is consistent with Example 24 accompanying IFRS 16, which shows an illustration that uses discounted lease payments over the fair value of the asset to calculate the proportion of the ROU asset retained in a sale and leaseback transaction.

View B: Recognise the ROU asset based on the portion of the right-of-use asset that has been retained. The deferred gain is deducted from the ROU asset. To the extent that the deferred gain exceeds the ROU asset, the net amount is subsequently released to profit or loss in a manner similar to the depreciation of ROU assets.

Proponents of View B believe that IFRS 16.100(a) provides specific guidance on the measurement of the ROU asset arising from a sale and leaseback transaction and there are clearly rights retained by the seller-lessee with the leaseback even though the lease payments are fully variable (and not based on an index or rate). Example 24 illustrates only one way to measure the retained interest in the fact pattern. However, it is not part of the standard and, as such, does not preclude other bases. Therefore, the proportion of the previous carrying amount of the asset that is retained should be determined on a rational basis (such as market rentals of the leaseback interest relative to the fair value of the underlying asset, as appropriate).

Accordingly, the seller-lessee would only recognise any gain on the portion of the rights transferred to the buyer-lessor. The deferred gain is then offset against the ROU asset.

The first sentence of paragraph 100(a) results in the recognition of the ROU asset of CU250,000 based on the proportion of the previous carrying amount of the asset that relates to the right-of-use retained (fair value of market rentals of the leaseback retained of CU450,000 / fair value of the underlying asset of CU1,800,000 * carrying amount of the underlying asset of CU1,000,000). However, the second sentence of the same paragraph requires a recognition of a deferred gain of CU200,000 (25% of the total gain of CU800,000 retained). These two sentences create conflict in the overall accounting in this fact pattern. Proponents of View B believe that the gain to be recognised upon the sale of the underlying asset is limited to the portion of the rights transferred to the buyer-lessor as this best reflects the economic substance that the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback, as explained in BC266 of IFRS 16.The balancing figure is included in the ROU asset or deferral depending on whether it is a debit or credit amount.

Upon the sale of the underlying asset, the seller-lessee records the following journal entries:

Dr		Cash	1,800,000	
	Cr	Gain on right transferred		(600,000)*
	Cr	Land		(1,000,000)
	Cr	Deferral		(200,000)**
(To account for the sale and leaseback transaction upon the disposal of the underlying asset)				

* The amount related to the gain on right transferred is limited to the portion of rights transferred to the buyer-lessor by reference to the market rental of the lease and the fair value of the underlying asset. The total gain is CU800,000 (sale consideration of CU1,800,000 - carrying amount of CU1,000,000) and the portion of rights transferred to the buyer-lessor is 75% ((fair value of the underlying asset of CU1,800,000 - fair value of the right of use retained estimated at the expected rentals of the lease of CU450,000) / fair value of the underlying asset of CU1,800,000).

** In this fact pattern, there is a net credit balance of CU200,000. In other situations, the ROU asset may exceed the deferred gain and thus result in a net ROU asset which is subsequently accounted for in accordance with paragraph 29 of IFRS 16.

While there is no specific guidance on the subsequent accounting for the deferred amount, it is appropriate to apply the subsequent measurement guidance related to ROU assets. Assuming that the seller-lessee applies the cost model as described in paragraph 30 of IFRS 16, it is appropriate to apply the guidance by analogy to the deferral and thus amortise the deferred balance to profit or loss throughout the lease term.

The following entries reflect the subsequent amortisation of the deferral throughout the lease term on a straight-line basis of CU20,000 (deferral of CU200,000/ lease term of 10 years) for the first year of the leaseback:

Dr	Deferral	20,000		
	Cr	Profit or loss	(20,000)	
(To account for the amortisation of deferral on a straight-line basis)				

<u>**View C: accounting policy choice**</u>

Both Views A and B are permissible. Therefore, there is an accounting policy choice to be made by the entity and it needs to be applied consistently.

Reasons for the Committee to address the issue:

a. Is the issue widespread and has, or is expected to have, a material effect on those affected?

Sale and leaseback transactions are commonly entered into by entities across all industries. In many instances, these transactions are material to the entity. We also observe many instances of leases with partially or even fully variable payments which are not based on an index or rate. As entities adopt IFRS 16 we believe that diversity in practice may occur with respect to accounting for sale and leaseback transactions with partially or fully variable leases under the new standard.

b. ***Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?***

In light of the potential material impact to many entities across a variety of industries, we believe that clarity is needed so that a consistent approach can be taken amongst IFRS reporters.

c. ***Can the issue be resolved efficiently within the confines of IFRS standards and the Conceptual Framework for Financial Reporting?***

Yes. We believe that consideration by the Committee is needed in this instance and that it can be resolved efficiently within the confines of IFRS standards and the Conceptual Framework for Financial Reporting.

d. ***Is the issue sufficiently narrow in scope that the Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Committee to undertake the due process that would be required when making changes to IFRS standards?***

We believe this issue is sufficiently narrow in scope that it can be addressed in an efficient manner.

e. ***Will the solution developed by the Committee be effective for a reasonable time period? The Committee will not add an item to its agenda if the issue is being addressed in a forthcoming standard and/or if a short-term improvement is not justified.***

We are unaware of any current or planned IASB project that will directly address this issue.