IFRS

STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Sale and leaseback with variable payments (IFRS 16)**		
Paper topic	Item for continuing discussion		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about a sale and leaseback transaction with variable payments. The submitter asked 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 Committee discussed this matter at its November 2019 meeting[1]. The Committee generally agreed with our analysis of how the seller-lessee accounts for the transaction, but asked that we analyse further the seller-lessee's accounting for the liability that arises in a sale and leaseback transaction.

3. This paper:

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

    (b) presents our updated research and analysis; and

[1] Agenda Paper 5 for the Committee's November meeting, and the webcast and audio recording of the Committee's discussion, can be accessed here.

(c) asks the Committee whether it agrees with our recommendation:

(i) not to add the matter addressed in the submission to its standard-setting agenda; but

(ii) to recommend an Annual Improvement that would specify how the seller-lessee applies IFRS 16's subsequent measurement requirements to the lease liability that arises in a sale and leaseback transaction.

Structure of the paper

4. This paper includes the following:

(a) background information (paragraphs 6–10);

(b) staff analysis applying IFRS Standards (paragraphs 11–51);

(c) should the Committee add the matter to its standard-setting agenda (paragraphs 52-63); and

(d) staff recommendation (paragraphs 64–65).

5. There are three appendices to this paper:

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

(b) Appendix B—excerpts from the November paper; and

(c) Appendix C—Illustrative Example 24 accompanying IFRS 16.

Background information

6. The submission outlined 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 in 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

7. The submitter asked 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 identified two ways of measuring the ROU asset and, consequently, the gain recognised.

8. 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.

9. 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'.

10. The submitter asked whether, in applying paragraph 100(a):

   (a) Seller-lessee takes into account the requirements in paragraph 24 of IFRS 16[2] 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[3]. 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.

   (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:

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

[2] 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.

[3] 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.

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:

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

Staff analysis applying IFRS Standards

What does IFRS 16 say?

11. 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.

12. When the transfer of an asset by the seller-lessee satisfies the requirements in 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*…

13. 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.

14. Illustrative Example 24 accompanying IFRS 16 (reproduced in Appendix C) 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.

15. As explained in paragraph BC266 (reproduced above in paragraph 13), the Board developed the measurement 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* the right to use the asset for the period of the lease. 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, thus, 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

16. 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 IFRS 15's requirements 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.

17. 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

18. 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.

19. IFRS 16 does not prescribe a particular method for calculating that proportion. The Board's explanation in paragraph BC266 (see paragraph 13 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).

20. In the example described in paragraph 8 and 10(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:

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

21. Accordingly, in the example described in paragraph 8, the seller-lessee measures the ROU asset at CU250,000, calculated as:

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

Gain on rights transferred to the buyer-lessor

22. Paragraph 100(a) of IFRS 16 also specifies how to determine 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 earlier, 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 asset's previous carrying amount—as a consequence, there is no gain or loss to recognise relating to the 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'.

23. 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 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 above in paragraph 19). 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:

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

24. In the example described in paragraph 8, the seller-lessee recognises a gain of CU600,000, calculated as:

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

25. 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

26. Paragraphs 41–45 of the November paper (reproduced in Appendix B to this paper) explain why in our view it is not possible to measure the ROU asset at zero in the transaction described in the submission.

Financial liability

27. As illustrated in paragraph 25 above, applying IFRS 16's sale and leaseback requirements, the seller-lessee recognises a liability at the date of the sale and leaseback transaction. That liability reflects the seller-lessee's obligation to make payments to the buyer-lessor over the lease term, and therefore meets the definition of a financial liability in IAS 32 *Financial Instruments: Presentation*—ie it is a contractual obligation to deliver cash to another entity.

28. At the November meeting, some Committee members asked:

(a) whether the seller-lessee accounts for the financial liability as a lease liability applying IFRS 16 or, instead, applying IFRS 9 *Financial Instruments*; and

(b) if accounted for as a lease liability, how the seller-lessee applies IFRS 16 to that lease liability, particularly in the transaction described in the submission for which leaseback payments are variable calculated as a percentage of the seller-lessee's revenue.

29. We note that a financial liability arises for the seller-lessee in *all* sale and leaseback transactions (assuming—as we would expect—that the seller-lessee is obliged to make payments to the buyer-lessor over the lease term). Therefore, the question of whether to apply IFRS 16 or IFRS 9 to that financial liability is relevant for *all* sale and leaseback transactions. It is not only a question when some or all of the leaseback payments are variable.

Does IFRS 16 apply to the financial liability that arises in a sale and leaseback transaction?

30. A lease liability meets the definition of a financial liability. Therefore, whether IFRS 16 or IFRS 9 applies to the financial liability that arises in a sale and leaseback transaction is a question of scope. Paragraph 2.1(b) of IFRS 9 excludes from its scope 'rights and obligations under leases to which IFRS 16 *Leases* applies'. We therefore first considered whether the financial liability is a lease liability to which IFRS 16 applies.

31. IFRS 16 defines a lease as 'a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. Paragraph 9 of IFRS 16 explains that 'a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration'. Accordingly, when a contract is or contains a lease, the lessee (a) obtains the right to control the use of an identified asset for a period of time; and (b) pays consideration in exchange for that right.

32. Paragraph 98 of IFRS 16 states (*emphasis* added) '…both the seller-lessee and the buyer-lessor shall account for the transfer contract *and the lease* applying paragraphs 99-103.' Paragraph BC262(a) states (*emphasis* added):

> …Consequently, if there are no features in a sale and leaseback transaction that prevent sale accounting, the buyer-lessor is

> considered to obtain control of the underlying asset, and immediately transfer *the right to control the use* of that asset to the seller-lessee for the lease term. The fact that the buyer-lessor purchases the underlying asset from the entity that is the lessee in the *subsequent leaseback* does not change the buyer-lessor's ability to obtain control of the underlying asset.

33. Consequently, in a sale and leaseback transaction (that satisfies IFRS 15's requirements to account for the transfer as a sale), the seller-lessee transfers the underlying asset to the buyer-lessor and then immediately obtains the right to control the use of the asset in exchange for payments to the buyer-lessor. The transaction therefore contains a lease. Because of this, we conclude that any payments the seller-lessee makes to the buyer-lessor over the lease term are in exchange for its right to use the underlying asset—in other words, the seller-lessee's obligation to make payments to the buyer-lessor relate to the lease. Accordingly, the liability is a lease liability to which IFRS 16 applies.

34. This conclusion aligns with paragraph 100(a) of IFRS 16 that specifies a seller-lessee's measurement of 'the right-of-use asset arising from the leaseback'—if the seller-lessee has obtained a ROU asset at the date of a sale and leaseback transaction, then it follows that the seller-lessee's obligation to make payments to the buyer-lessor over the lease term is a liability that relates to obtaining that right of use.

Limited research performed

35. To identify how entities account for sale and leaseback transactions applying IFRS 16, we performed a limited review of publicly available financial statements or other investor information. We identified eight entities that recognise a lease liability arising in a sale and leaseback transaction and none that recognise an IFRS 9 financial liability.[4] In all instances, we were unable to determine whether any leaseback payments were variable.

[4] There were two additional entities with sale and leaseback transactions for which we were unable to determine whether the liability recognised was considered a lease liability or an IFRS 9 financial liability.

How to apply IFRS 16 in accounting for the lease liability

36. As discussed earlier in the paper, paragraph 100(a) of IFRS 16 specifies how the seller-lessee measures the ROU asset arising from a leaseback and the amount of gain or loss it recognises at the date of the transaction. This means that the seller-lessee does *not* apply the measurement requirements in paragraphs 23–24 of IFRS 16, which would otherwise apply when initially measuring a ROU asset. Similarly, a consequence of the requirements in paragraph 100(a) is that the initial measurement of the lease liability is determined by the measurement of the ROU asset and the gain or loss on the transaction recognised applying paragraph 100(a). This in turn means that the seller-lessee does *not* apply the measurement requirements in paragraphs 26-27 of IFRS 16, which would otherwise apply when initially measuring a lease liability.

37. To illustrate using the example described in paragraph 8, 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. Lease liability		450,000
CR. Gain on rights transferred		600,000

38. The measurement of the lease liability of CU450,000 is determined as a consequence of how the seller-lessee measures the ROU asset of CU250,000 and determines the gain of CU600,000 applying paragraph 100(a). The liability represents the seller-lessee's obligation to make payments to the buyer-lessor over the lease term. Because of how paragraph 100(a) requires the seller-lessee to measure the ROU asset and determine the gain or loss on the transaction, that measurement of CU450,000 represents the value of the ROU asset.

39. Based on our analysis, we conclude that paragraph 100(a) specifies the accounting for a sale and leaseback transaction at the date of the transaction. However, the sale and leaseback requirements in IFRS 16 do not specify how the seller-lessee accounts for the ROU asset and the lease liability *after* the date of the transaction. Consequently,

the seller-lessee would apply the subsequent measurement requirements applicable for any ROU asset and lease liability—ie:

(a) paragraphs 29–35 of IFRS 16 for the ROU asset; and

(b) paragraphs 36–38 of IFRS 16 for the lease liability.

Subsequent measurement of the lease liability

40. Paragraphs 36–38 of IFRS 16 state:

> 36 After the commencement date, a lessee shall measure the lease liability by:
>
> (a) increasing the carrying amount to reflect interest on the lease liability;
>
> (b) reducing the carrying amount to reflect the lease payments made; and
>
> (c) remeasuring the carrying amount to reflect any reassessment or lease modifications specified in paragraphs 39–46, or to reflect revised in-substance fixed lease payments (see paragraph B42).
>
> 37 Interest on the lease liability in each period during the lease term shall be the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. The periodic rate of interest is the discount rate described in paragraph 26, or if applicable the revised discount rate described in paragraph 41, paragraph 43 or paragraph 45(c).
>
> 38 After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:
>
> (a) interest on the lease liability; and
>
> (b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs.

41. When leaseback payments comprise payments that meet the definition of lease payments in IFRS 16[5], we would expect the initial measurement of the lease liability to be similar to that applying paragraphs 26–27 of IFRS 16. Consequently, we would expect the seller-lessee to apply paragraphs 36–38 largely as it would for any other lease liability.

42. However, paragraphs 36–38 of IFRS 16 were drafted without contemplating a situation in which the measurement of the lease liability might include payments that do not meet the definition of lease payments. The sale and leaseback transaction in the submission provides an example of such a situation—this is because the leaseback payments comprise variable lease payments linked to the seller-lessee's revenue (that are not in-substance fixed payments). Those payments do not meet IFRS 16's definition of lease payments.

43. The following paragraphs illustrate how, in our view, the seller-lessee could apply paragraphs 36–38 when the initial measurement of the lease liability is different from that applying paragraphs 26–27 of IFRS 16. These paragraphs again use the example described in paragraph 8 to illustrate. Using that example, assume that:

    (a) Seller-lessee recognises a lease liability of CU450,000 at the date of the transaction (as illustrated in paragraph 37). The measurement of that liability includes expected leaseback payments in Year 1 of CU50,000, discounted at Seller-lessee's incremental borrowing rate;

    (b) the interest on the lease liability for Year 1 is CU10,000 (calculated using Seller-lessee's incremental borrowing rate); and

    (c) Seller-lessee makes payments of CU52,000 for Year 1 (calculated as a percentage of its revenue generated using the asset during that period).

[5] IFRS 16 defines lease payments as 'payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following: (a) fixed payments (including in-substance fixed payments), less any lease incentives; (b) variable lease payments that depend on an index or a rate; (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; (d) payments of penalties for terminating the lease, if the lease term reflect the lessee exercising an option to terminate the lease. For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees…'.

44. In this example, in Year 1 of the lease, Seller-lessee:

(a) increases the carrying amount of the liability to reflect interest on the lease liability using Seller-lessee's incremental borrowing rate (paragraphs 36(a) and 38(a) of IFRS 16):

DR. Interest expense	10,000	
CR. Lease liability		10,000

(b) reduces the carrying amount of the liability to reflect the expected leaseback payments included in the measurement of the lease liability (CU50,000). Any difference between the actual amount paid (CU52,000) and the amount included in the lease liability (CU50,000) are variable payments not included in the measurement of the lease liability (as described in paragraph 38(b) of IFRS 16). Accordingly, applying paragraph 38(b) Seller-lessee recognises those payments in profit or loss:

DR. Lease liability	50,000	
DR. Expense	2,000	
CR. Cash		52,000

(c) does not remeasure the lease liability to reflect any reassessment of future variable lease payments. This is because paragraphs 39–43 of IFRS 16—which specify requirements for reassessing the lease liability—neither require nor permit an entity to reassess the lease liability for changes in variable lease payments that do not depend on an index or rate.

(d) if the contract were to be modified, then Seller-lessee would apply the lease modification requirements in paragraphs 44–46 of IFRS 16.

45. Although in our view a seller-lessee could apply paragraphs 36–38 of IFRS 16 as described above, we acknowledge that the requirements are not as complete as they might be. The approach set out in paragraph 44 would require the seller-lessee to:

(a) reduce the carrying amount of the liability (as described in paragraph 36(b)) to reflect the expected leaseback payments included in the measurement of the lease liability, rather than the actual payments made; and

(b) determine the leaseback payments included in the measurement of the lease liability as those that, when discounted using its incremental borrowing rate, result in an amount that equals the carrying amount of the lease liability on initial recognition.

46. Paragraphs 54-61 of this paper discuss whether IFRS 16's sale and leaseback requirements should be enhanced to address the measurement of the lease liability that arises in such a transaction.

Staff conclusion

47. 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, the seller-lessee:

(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.

48. 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.

49. IFRS 16 does not prescribe a 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.

50. If the seller-lessee makes payments to the buyer-lessor over the lease term, then the sale and leaseback transaction also gives rise to a lease liability. The initial measurement of the lease liability is a consequence of the measurement of the ROU asset and the gain recognised applying paragraph 100(a).

51. The seller-lessee subsequently measures the ROU asset applying paragraphs 29–35 of IFRS 16, and the lease liability applying paragraphs 36–38 of IFRS 16.

Question 1 for the Committee

1. Does the Committee agree with our analysis of the application of IFRS 16 to the transaction described in the submission, summarised in paragraphs 47-51 of this paper?

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

Is the matter widespread and expected to have a material effect on those affected?[6]

52. The question in the submission arises for sale and leaseback transactions for which some or all leaseback payments fail to meet IFRS 16's definition of lease payments. Although we are unaware of sale and leaseback transactions with such leaseback payments, respondents to our outreach said these transactions may occur more frequently in the future. In particular, some respondents said 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 mentioned energy production facilities where some or all leaseback payments might be based on the electricity produced, and also bearer plants in the agriculture industry.

[6] Paragraph 5.16(a) of the *Due Process Handbook*

Is it necessary to add to or change IFRS Standards to improve financial reporting?[7]

Matter raised in the submission

53. The submitter asked how the seller-lessee measures the ROU asset and determines the gain or loss recognised at the date of a sale and leaseback transaction with variable payments. Based on our analysis, we conclude that IFRS 16 provides an adequate basis for an entity to determine the accounting for such sale and leaseback transactions at the date of the transaction. We therefore recommend that the Committee publish a tentative agenda decision that explains how the seller-lessee accounts for a sale and leaseback transaction with variable payments at that date.

Measurement of the lease liability

54. We acknowledge that IFRS 16 is not as complete as it might be regarding the subsequent measurement of the lease liability that arises in a sale and leaseback transaction. The initial measurement of the lease liability is a consequence of how the ROU asset is measured (and the gain or loss on the transaction determined) applying paragraph 100(a); it reflects the value of the right of use retained by the seller-lessee. This means that the initial measurement of the lease liability is not necessarily the same as it would be if the seller-lessee were to apply paragraphs 26–27 of IFRS 16. In our view, a seller-lessee could apply the existing requirements as described in paragraph 44 of this paper, however that approach is not fully prescribed in the Standard.

Should IFRS 16 be amended to address the measurement of the lease liability?

55. The submitter asked how the seller-lessee accounts for a particular sale and leaseback transaction at the date of the transaction—the submitter did not directly ask about the subsequent measurement of the lease liability that arises in such a transaction. We also note that our limited research (see paragraph 35) indicates that entities enter into sale and leaseback transactions and those entities have determined how to apply

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

IFRS 16 to those transactions. Therefore, we have not directly been informed of difficulties or differences in determining how to measure the lease liability that arises in a sale and lease transaction.

56. Further, there is always a cost to standard-setting, no matter how narrow the scope. Therefore, we need to be confident that there are sufficient expected benefits from any standard-setting to justify the costs.

57. If IFRS 16 were to be amended, the sale and leaseback requirements could be enhanced to specify that the seller-lessee recognises a lease liability at the date of the transaction, and how to apply paragraphs 36–38 of IFRS 16 in subsequently measuring that lease liability. Such an amendment could clarify that, in applying paragraphs 36–38, the seller-lessee:

(a) determines the lease payments made (as described in paragraph 36(b)) as the payments included in the measurement of the lease liability. The payments included in that measurement are those that, when discounted using the discount rate described in paragraph 37, result in an amount equal to the carrying amount of the lease liability; and

(b) applies paragraph 38 in accounting for any difference between the payments made for the lease and those included in the measurement of the lease liability.

58. In our view, such an amendment would meet the criteria for annual improvements in paragraph 6.11-6.14 of the *Due Process Handbook*. To meet these criteria, the amendment should not propose a new principle or change an existing principle, and would need to be limited to:

(a) clarifying the wording in a Standard; or

(b) correcting relatively minor unintended consequences, oversights or conflicts between existing requirements.

59. We think a possible amendment (as described above) would meet the first of these criteria—it would clarify the application of paragraphs 36–38 of IFRS 16 to lease liabilities that arise in a sale and leaseback transaction. That clarification would not propose a new principle or change an existing principle. The possible amendment

could also be viewed as meeting the second criterion—it would correct a relatively minor oversight in the development of IFRS 16.

60. We see benefits in amending IFRS 16 to address the measurement of lease liabilities arising in a sale and leaseback transaction. Although we have not directly been informed of difficulties or differences in determining that measurement, we think that the submitter's question may have arisen because of uncertainty about the measurement of the liability. We also note that, when sale and leaseback transactions occur, they often relate to high-value items of property, plant and equipment—for example, land and buildings, aircraft, energy production facilities, large telecommunications equipment. Those transactions are often material for seller-lessees and, consequently, it is important for investors that entities apply IFRS 16 consistently to those transactions.

61. For this reason, in our view the expected benefits of amending IFRS 16 to address the measurement of lease liabilities in a sale and leaseback transaction would outweigh the expected costs of making that amendment.

Can the matter be resolved efficiently (is it sufficiently narrow in scope) and would any solution developed be effective for a reasonable period of time?[8]

62. Addressing the measurement of lease liabilities arising in a sale and leaseback transaction is a narrow scope matter that would in our view meet the criteria for annual improvements. It could therefore be resolved efficiently.

63. The Board does not have any projects on its work plan or in its research pipeline on sale and leaseback transactions. The Board will undertake a Post-implementation Review of IFRS 16 in the future, however no date is yet set for that review. We note that most entities are only now preparing their first annual financial statements applying IFRS 16. Consequently, we would expect any amendment to IFRS 16 to be effective for a reasonable period of time.

[8] Paragraphs 5.16(c), 5.17 and 5.21 of the *Due Process Handbook*

Staff recommendation

64. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraphs 52-63 of this paper), we recommend the following:

    (a) that the Committee does not add the matter addressed in the submission to its standard-setting agenda. Instead, we recommend publishing a tentative agenda decision that outlines how an entity accounts for a sale and leaseback transaction with variable payments at the date of the transaction; and

    (b) an Annual Improvement that would specify how the seller-lessee applies IFRS 16's subsequent measurement requirements to the lease liability that arises in a sale and leaseback transaction.

65. Appendix A to this paper sets out the proposed wording of the tentative agenda decision.

Questions 2 - 4 for the Committee

2. Does the Committee agree with our recommendation not to add the matter addressed in the submission to its standard-setting agenda?

3. Does the Committee agree to recommend that the Board undertake an Annual Improvement that would specify how the seller-lessee applies IFRS 16's subsequent measurement requirements to the lease liability that arises in a sale and leaseback transaction?

4. 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 in IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale of the asset. 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 method for 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 payments for the lease (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 (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 seller-lessee also recognises a lease liability, which reflects its obligation to make payments to the buyer-lessor for the right to use the asset over the lease term.

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

Appendix B—excerpts from the November paper

B1. This appendix reproduces excerpts from the November 2019 staff paper.

Paragraphs 41–45 of Agenda Paper 5

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 8 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.

Appendix C—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

Buyer-lessor

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.