IFRIC POTENTIAL AGENDA ITEM 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.

<u>View A: A right-of-use asset is not recognised</u>
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.