IFRS

STAFF PAPER

April 2020

IASB Meeting

Project	Lease Liability in a Sale and Leaseback		
Paper topic	Amendment to IFRS 16		
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Introduction and purpose

1. At its March 2020 meeting, the IFRS Interpretations Committee (Committee) discussed 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 concluded that IFRS 16 provides an adequate basis for an entity to determine, at the date of the transaction, the accounting for the sale and leaseback transaction submitted. Consequently, the Committee tentatively decided not to add the matter addressed in the submission to the standard-setting agenda and, instead, published a tentative agenda decision.

3. However, the Committee's discussions highlighted 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 Committee therefore recommended that the International Accounting Standards Board (Board) amend IFRS 16 to specify how a seller-lessee applies IFRS 16's subsequent measurement requirements to the lease liability that arises in such a transaction. This paper asks the Board whether it agrees with the Committee's recommendation to undertake narrow-scope standard-setting with respect to sale and leaseback transactions.

Structure of the paper

4. This paper includes:

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

   (b) subsequent measurement (paragraphs 11–20);

   (c) possible amendment to IFRS 16 (paragraphs 21–38), including:

      (i) sale and leaseback transactions with variable lease payments (paragraphs 23–33); and

      (ii) lease modifications and changes in lease term related to a sale and leaseback transaction (paragraphs 34–38);

   (d) staff recommendations (paragraphs 39–40);

   (e) question for the Board; and

   (f) next step (paragraph 41).

5. The appendix to this paper includes a worked example applying the proposals in this paper.

Background information

6. The Committee's tentative agenda decision (published in IFRIC Update March 2020) provides information about (a) the transaction considered by the Committee, and (b) the Committee's tentative conclusion on how the seller-lessee accounts for that transaction at the date of the transaction. The tentative agenda decision is reproduced below:

> ***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 (PPE) to another entity (buyer-lessor) and leases the asset back for five years.

b. the transfer of the PPE satisfies the requirements in IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale of the PPE. The amount paid by the buyer-lessor to the seller-lessee in exchange for the PPE equals the PPE's fair value at the date of the transaction.

c. 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 PPE during the five-year lease term. The seller-lessee has determined that the variable payments are not in-substance fixed payments as described in IFRS 16.

The request asked how, in the transaction described, 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 of IFRS 16. Paragraph 100 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 PPE 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 right of use it retains via the leaseback to the rights comprising the entire PPE. IFRS 16 does not prescribe a method for determining that proportion. In the transaction described in the request, the seller-lessee could determine the proportion by comparing, for example, (a) the present value of expected payments for the lease (including those that are variable), to (b) the fair value of the PPE at the date of the transaction.

The gain or loss the seller-lessee recognises 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 the seller-lessee retains is not remeasured as a result of the transaction (it is measured as a proportion of the PPE's previous carrying amount), the amount of the gain or loss recognised relates only to the rights transferred to the buyer-lessor. Applying paragraph 53(i) of IFRS 16, the seller-lessee discloses gains or losses arising from sale and leaseback transactions.

The seller-lessee also recognises a lease liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate. The initial measurement of the lease liability is a consequence of how the right-of-use asset is measured—and the gain or loss on the sale and leaseback transaction determined—applying paragraph 100(a) of IFRS 16.

Illustrative example

Seller-lessee enters into a sale and leaseback transaction whereby it transfers an asset (PPE) to Buyer-lessor, and leases that PPE back for five years. The transfer of the PPE satisfies the requirements in IFRS 15 to be accounted for as a sale of the PPE.

The carrying amount of the PPE 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 PPE is CU1,800,000 (the fair value of the PPE at that date). All the payments for the lease (which are at market rates) are variable, calculated as a percentage of Seller-lessee's revenue generated using the PPE during the five-year lease term. At the date of the transaction, the present value of the expected payments for the lease is CU450,000. There are no initial direct costs.

Seller-lessee determines that it is appropriate to calculate the proportion of the PPE that relates to the right of use retained using the present value of expected payments for the lease. On this basis, the proportion of the PPE that relates to the right of use retained is 25%, calculated as CU450,000 (present value of expected payments for the lease) ÷ CU1,800,000 (fair value of the PPE). Consequently, the proportion of the PPE that relates to the rights transferred to Buyer-lessor is 75%, calculated as (CU1,800,000 - CU450,000) ÷ CU1,800,000.

Applying paragraph 100(a), Seller-lessee:

a. measures the right-of-use asset at CU250,000, calculated as CU1,000,000 (previous carrying amount of the PPE) × 25% (proportion of the PPE that relates to the right of use it retains).

b. 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. This gain is calculated as CU800,000 (total gain on sale of the PPE (CU1,800,000 – CU1,000,000)) × 75% (proportion of the PPE that relates to rights transferred to Buyer-lessor).

At the date of the transaction, Seller-lessee accounts for the transaction as follows:

Dr. Cash	*CU1,800,000*	
Dr. Right-of-use asset	*CU250,000*	
Cr. PPE		*CU1,000,000*
Cr. Lease liability		*CU450,000*
Cr. Gain on rights transferred		*CU600,000*

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine, at the date of the transaction, the accounting for the sale and leaseback transaction described in the request….

7. As noted above, the applicable requirements for this transaction are specified in paragraph 100(a) of IFRS 16. Paragraph BC266 explains the rationale for the Board's decisions in developing those requirements:

> 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.

8. Paragraph BC266 explains that the Board developed the initial 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. The seller-lessee therefore does not remeasure the right of use retained and recognises only the amount of the gain or loss that relates to the rights transferred to the buyer-lessor.

9. In measuring the right-of-use (ROU) asset, the tentative agenda decision notes that IFRS 16 does not prescribe a particular method for determining the proportion of the asset transferred to the buyer-lessor that relates to the right of use retained. The explanation in paragraph BC266 (reproduced 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. In our view, the seller-lessee would therefore use 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).

10. That measurement of the ROU asset is then the basis for the calculation of the gain or loss recognised at the date of the transaction and is also the basis for the initial measurement of the lease liability. Because of how paragraph 100(a) of IFRS 16 requires the seller-lessee to measure the ROU asset and determine the gain or loss on the transaction, the initial measurement of the lease liability represents the value of the ROU asset at that date.

Subsequent measurement

11. In its discussions, the Committee observed that IFRS 16's sale and leaseback requirements 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.

12. The following paragraphs discuss how the seller-lessee applies paragraphs 36-38 of IFRS 16 to the lease liability, particularly in a transaction such as the one considered by the Committee (ie a sale and leaseback transaction in which payments for the lease are variable calculated as a percentage of the seller-lessee's revenue over the lease term).

What IFRS 16's subsequent measurement requirements say

13. 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.

Applying IFRS 16's subsequent measurement requirements

14. When payments for the lease (in a sale and leaseback transaction) comprise payments that meet the definition of lease payments in IFRS 16[1], we would expect the initial measurement of the lease liability to be similar to that applying paragraphs 26–27 of IFRS 16[2]—in other words, similar to the initial measurement of any lease liability that arises from a standalone lease. Consequently, we would expect the seller-lessee to apply paragraphs 36–38 largely as it would for any other lease liability.

15. 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

[1] 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…'.

[2] Paragraph 26 of IFRS 16 requires a lessee to initially measure the lease liability at the present value of lease payments that are not paid at the commencement date. Paragraph 27 of IFRS 16 specifies that the lease payments included in the initial 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.

considered by the Committee provides an example of such a situation—this is because the payments for the lease 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.

16. 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 use the example described in tentative agenda decision (see paragraph 6 above) to illustrate. Using that example, assume that:

    (a) Seller-lessee recognises a lease liability of CU450,000 at the date of the transaction (calculated as in paragraph 6). The measurement of that liability includes expected payments for the lease in Year 1 of CU91,000, discounted at Seller-lessee's incremental borrowing rate of 3.5%;

    (b) the interest on the lease liability for Year 1 is CU15,750 (calculated using Seller-lessee's incremental borrowing rate); and

    (c) Seller-lessee makes payments of CU92,000 for Year 1 (calculated as a percentage of its revenue generated using the asset during that period).

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

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

DR. Interest expense	15,750	
CR. Lease liability		15,750

    (b) reduces the carrying amount of the lease liability to reflect the expected payments for the lease included in the measurement of that liability (CU91,000). Any difference between the actual amount paid (CU92,000) and the amount included in the lease liability (CU91,000) 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	91,000	
DR. Expense	1,000	
CR. Cash		92,000

(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.

18. Although 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 and, in our view, could be improved. For example, the approach set out in paragraph 17 would require the seller-lessee to reduce the carrying amount of the liability (as described in paragraph 36(b)) to reflect the expected payments for the lease included in the measurement of the lease liability, rather than the actual payments made.

The Committee's discussion

19. At its March 2020 meeting, the Committee did not disagree with our view on how a seller-lessee could apply IFRS 16's subsequent measurement requirements to the lease liability that arises in a sale and leaseback transaction. Nonetheless, the Committee agreed that IFRS 16's requirements could be improved in this respect. Consideration of this submission identified a gap in IFRS 16's requirements relating to the subsequent measurement of the lease liability that arises in a sale and leaseback transaction. The Committee therefore recommended a narrow-scope amendment to IFRS 16 to specify how the seller-lessee applies IFRS 16's subsequent measurement requirements to that lease liability—the possible amendment is discussed in the next section of the paper.

20. The Committee was of the view that the expected benefits of such an amendment would outweigh the cost of standard-setting. The Committee observed that it was not yet aware of significant difficulties or differences in applying IFRS 16's subsequent measurement requirements to sale and leaseback transactions. However, 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.

Possible amendment to IFRS 16

21. In our view, the sale and leaseback requirements in IFRS 16 could be improved by specifying how to apply paragraphs 36–38 of IFRS 16 in subsequently measuring the lease liability that arises in a sale and leaseback transaction. The following paragraphs discuss:

    (a) application of those requirements to sale and leaseback transactions with variable lease payments—both those that depend on an index or rate and those that do not (see paragraphs 23–33); and

    (b) application of the requirements to lease modifications and changes in lease term related to sale and leaseback transactions (see paragraphs 34–38).

22. In developing a possible amendment, it is important, in our view, not to change any of the underlying principles or existing requirements in IFRS 16, but rather to add to those requirements in the context of sale and leaseback transactions. Any wider reconsideration of IFRS 16's principles and requirements would be appropriate only as part of its Post-implementation Review, and not before.

Sale and leaseback transactions with variable lease payments

23. As explained in the tentative agenda decision (see paragraph 6 above), the measurement of the lease liability is a consequence of how a seller-lessee measures the ROU asset and determines the gain or loss applying paragraph 100(a). Because of those requirements in paragraph 100(a), that measurement of the lease liability (in effect) represents the value of the ROU asset. Accordingly, it would be expected to largely reflect expected payments for the lease (at market rates).

24. To explain, in the illustrative example in the tentative agenda decision, Seller-lessee initially measures the lease liability at CU450,000—this represents the value of the five-year right of use retained by Seller-lessee and is measured at the present value of

the expected payments for the lease (at market rates). However, Seller-lessee could have used another method to calculate the value of the right of use it retains—for example, it could have determined the expected residual value of the asset at the end of the leaseback and deducted that amount from the fair value of the asset of CU1,800,000. We think any method used should result in a similar value for the ROU asset. Therefore, regardless of the method used, the initial measurement of the lease liability would—either directly or indirectly—reflect expected payments for the lease (at market rates).

25. In developing subsequent measurement requirements, we view it as important that those requirements do not permit the recognition of additional amounts of gain or loss on the sale of the asset beyond the gain or loss recognised at the date of the sale and leaseback transaction. So, in the example in paragraph 6 of this paper, it is important that the subsequent measurement requirements would not permit the recognition of any gain on the sale beyond the CU600,000 gain recognised at the date of the transaction. We view this as important because the recognition of any additional gain or loss:

    (a) would contradict the Board's objective and rationale in developing IFRS 16's sale and leaseback requirements (see paragraph BC266 reproduced in paragraph 7 of this paper); and

    (b) would result in recognising a gain or loss when no underlying transaction or event has occurred to give rise to such a gain or loss.

26. Consequently, our proposals regarding subsequent measurement of the lease liability aim to ensure that the seller-lessee would not remeasure that liability in a way that would permit or require the seller-lessee to exclude expected payments for the lease.

27. With this in mind, we would propose that, for sale and leaseback transactions with variable lease payments, any amendment to IFRS 16 should 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;

(b) does not remeasure the lease liability to reflect any reassessment of future variable lease payments; and

(c) 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.

28. Paragraph 17 of this paper illustrates those proposals for the sale and leaseback transaction illustrated in the tentative agenda decision published in March 2020. In that example, the lease payments made in Year 1 (CU92,000) were higher than initially expected (CU91,000), and thus Seller-lessee would recognise CU1,000 (as a debit) in profit or loss in Year 1. If that example were changed such that actual lease payments made in Year 1 were CU89,000, then the proposals would result in the recognition of CU2,000 (as a credit) in profit or loss in that year.

29. This approach would ensure that:

(a) there would be no additional gain or loss recognised on the sale and leaseback transaction beyond that required by paragraph 100(a) of IFRS 16 at the date of the transaction; and

(b) the requirements would not be unduly burdensome. The Board could require a seller-lessee to remeasure the lease liability if the seller-lessee's expectation of future payments for the lease were to change. However, we do not see significant benefit in requiring seller-lessees to do that, particularly because IFRS 16 includes various simplifications to the measurement of lease liabilities that arise from standalone lease contracts.

30. The appendix to this paper sets out a worked example, using the example in the tentative agenda decision, showing the seller-lessee's accounting for each of the five years of the lease.

Variable lease payments that depend on an index or rate

31. The sale and leaseback transaction considered by the Committee was one in which some or all of the payments for the lease (a) are variable; (b) do not depend on an index or a rate; and (c) are not in-substance fixed payments. We are proposing to add requirements to IFRS 16 for such a transaction, in particular because the initial

measurement of the lease liability arising from the transaction would reflect payments that would not ordinarily be included in the initial measurement of lease liabilities.

32. This could also be the case for sale and leaseback transactions with variable lease payments based on an index or rate. As explained in paragraph 23, the initial measurement of the lease liability arising from a sale and leaseback transaction reflects expected payments for the lease. Accordingly, in a sale and leaseback transaction with variable payments that depend on an index or rate, the initial measurement of the lease liability would reflect expected future changes in the reference index or rate. However, IFRS 16 has simplified measurement requirements for leases with variable payments based on an index or rate. A lessee initially measures the lease liability to reflect the index or rate at the commencement date and, therefore, the initial measurement of any lease liability (other than those arising from a sale and leaseback transaction) would exclude expected future changes to the reference index or rate.

33. We note that, in many cases, any difference between the initial measurement of (a) the lease liability in a sale and leaseback transaction with variable payments based on an index or rate, and (b) other lease liabilities with such payments should be relatively small. Nonetheless, there can be differences. We therefore recommend that the proposed amendment apply to sale and leaseback transactions with variable lease payments that depend on an index or rate as well as those with variable lease payments that do not.

Lease modifications and changes in lease term related to a sale and leaseback transaction

34. In recommending narrow-scope standard-setting to the Board, some Committee members mentioned the need to consider how a seller-lessee accounts for lease modifications or changes in the lease term of a sale and leaseback transaction. The following paragraphs discuss this further.

35. If a lease is modified (and the modification is not accounted for as a separate lease) or there is a change in the lease term, paragraphs 40 and 45 of IFRS 16 require the lessee to remeasure the lease liability by discounting (*emphasis added)* 'the revised *lease payments* using a revised discount rate'.

36. In a sale and leaseback transaction with variable payments that do not meet the definition of lease payments (such as the transaction discussed by the Committee), there is a risk that, without clarification, a modification or change in the lease term of the leaseback could result in measuring the lease liability arising from the transaction differently from its initial measurement (to exclude variable payments that do not depend on an index or rate). This in turn could result in the seller-lessee inadvertently recognising additional gain or loss on the sale and leaseback transaction as a result of the modification or change in the lease term. In our view, this would be inappropriate.

37. To explain, assume in the example illustrated in the tentative agenda decision that Seller-lessee and Buyer-lessor agree to a modification to the lease in Year 2. That modification changes the calculation of the leaseback payments but those payments remain fully variable linked to Seller-lessee's revenue over the remaining lease term—therefore, the nature of the leaseback payments remain the same as in the original contract and would continue to fail to meet IFRS 16's definition of lease payments. In our view, Seller-lessee should account for that modification by remeasuring the lease liability, discounting the revised *expected payments for the lease* using a revised discount rate at the date of the modification. It would be inappropriate to remeasure the lease liability to zero, on the basis that the leaseback payments do not meet the definition of lease payments.

38. Consequently, we would propose clarifying as part of the narrow-scope amendment to IFRS 16 that for lease modifications or changes in the lease term of a sale and leaseback transaction, the seller-lessee remeasures the lease liability by discounting the revised *expected payments for the lease* using a revised discount rate. Subsequently measuring the lease liability in a similar way to its initial measurement (ie to reflect expected payments for the lease) aligns with our objective of avoiding the recognition of any additional gain or loss on the sale and leaseback transaction.

Staff recommendation

39. Based on the Committee's discussion and the analysis in this paper, we recommend a narrow-scope amendment to IFRS 16 to specify that:

    (a) in applying paragraphs 36–38 of IFRS 16 to a sale and leaseback transaction with variable lease payments, a seller-lessee:

        (i) 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;

        (ii) does not remeasure the lease liability to reflect any reassessment of future variable lease payments; and

        (iii) 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.

    (b) in applying paragraphs 40 and 45 of IFRS 16 to lease modifications and changes in lease term related to a sale and leaseback transaction, a seller-lessee determines the revised lease payments as the revised expected payments for the lease.

40. The illustrative examples accompanying IFRS 16 include an example illustrating how, at the date of the transaction, the seller-lessee and buyer-lessor accounts for a sale and leaseback transaction with fixed leaseback payments (Illustrative Example 24). If the Board agrees with our recommendation to propose a narrow-scope amendment to IFRS 16, we would also recommend developing an additional example that would illustrate the seller-lessee's accounting for a sale and leaseback transaction with variable payments, both at the date of the transaction and subsequently throughout the lease term.

Question for the Board
Does the Board agree with our recommendation to amend IFRS 16 and the illustrative examples accompanying IFRS 16 as summarised in paragraphs 39–40 of this paper?

Next step

41. If the Board agrees with our recommendations in this paper, we will bring a paper to a future Board meeting (a) discussing transition and effective date; and (b) setting out the due process steps completed to date and asking the Board for permission to begin the balloting process on the Exposure Draft.

Appendix: Worked example applying the proposals in the paper

A1. *Seller-lessee enters into a sale and leaseback transaction whereby it transfers an asset (PPE) to Buyer-lessor, and leases that PPE back for five years. The transfer of the PPE satisfies the requirements in IFRS 15 to be accounted for as a sale of the PPE.*

A2. *The carrying amount of the PPE 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 PPE is CU1,800,000 (the fair value of the PPE at that date). All the payments for the lease (which are at market rates) are variable and are calculated as seven per cent of Seller-lessee's revenue generated using the PPE during each year of the five-year lease term. Seller-lessee's incremental borrowing rate is 3.5 per cent (the interest rate implicit in the lease is not readily determinable).*

A3. *At the date of the transaction, Seller-lessee expects revenue generated using the PPE to be as shown in the following table. Therefore, Seller-lessee's expected payments for the lease over the five-year lease term are as follows[3]:*

	Year 1	Year 2	Year 3	Year 4	Year 5
Expected revenue	*1,300,000*	*1,400,000*	*1,450,000*	*1,480,000*	*1,500,000*
Expected lease payments[4]	*91,000*	*98,000*	*101,500*	*103,600*	*105,000*

A4. *The present value of the expected payments for the lease is CU450,000. There are no initial direct costs.*

[3] All amounts in CU.

[4] Calculated as seven per cent of Seller-lessee's expected revenue generated using the PPE.

Accounting at the date of the transaction

A5. At the date of the transaction, Seller-lessee accounts for the transaction as follows (the amounts are calculated as illustrated in the March 2020 tentative agenda decision, reproduced in paragraph 5 of this paper):

DR. Cash	CU1,800,000	
DR. Right-of-use asset	CU250,000	
CR. PPE		CU1,000,000
CR. Lease liability		CU450,000
CR. Gain on rights transferred		CU600,000

Subsequent accounting

A6. *Seller-lessee depreciates the right-of-use asset on a straight-line basis and makes the following actual payments for the lease*[5] *in each year of the lease term*[6]*:*

	Year 1	Year 2	Year 3	Year 4	Year 5
Payments for the lease	*92,000*	*100,000*	*100,000*	*104,000*	*104,000*

Year 1

A7. Applying the proposals in this paper, Seller-lessee would:

(a) depreciate the right-of-use asset (paragraph 31 of IFRS 16):

DR. Depreciation charge	50,000	
CR. Right-of-use asset		50,000

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

DR. Interest expense	15,750	
CR. Lease liability		15,750

[5] Calculated as seven per cent of Seller-lessee's actual revenue generated using the PPE.

[6] All amounts in CU.

(c) reduce the carrying amount of the lease liability to reflect the expected payments for the lease included in the measurement of that liability (CU91,000). Applying paragraph 38(b) Seller-lessee recognises any difference between the actual amount paid (CU92,000) and the amount included in the lease liability (CU91,000) in profit or loss:

DR. Lease liability	91,000	
DR. Expense	1,000	
CR. Cash		92,000

(d) not remeasure the lease liability (and the right-of-use asset) to reflect any reassessment of future variable lease payments.

A8. At the end of year 1:

(a) the right-of-use asset would be CU200,000 (cost of CU250,000 less accumulated depreciation of CU50,000); and

(b) the lease liability would be CU374,750 (liability at initial recognition of CU450,000 plus interest expense of CU15,750 less expected Year 1 payment for the lease of CU91,000).

Year 2–Year 5

Lease liability and right-of-use asset

A9. Seller-lessee would account for the lease liability and the right-of-use asset in a manner similar to that discussed for year 1 above. Accordingly, Seller-lessee's lease liability and right-of-use asset from Year 2 to Year 5 would be as follows[7]:

	Lease liability				**Right-of-use asset**		
Year	*Beginning balance*	*Expected payments for the lease*	*Interest expense*	*Ending balance*	*Beginning balance*	*Depreciation charge*	*Ending balance*
2	374,750	(98,000)	13,100	289,850	200,000	50,000	150,000
3	289,850	(101,500)	10,100	198,450	150,000	50,000	100,000
4	198,450	(103,600)	6,900	101,750	100,000	50,000	50,000
5	101,750	(105,000)	3,250	-	50,000	50,000	-

Difference between actual and expected payments for the lease

A10. Seller-lessee would recognise any difference between the actual amount paid and the amount included in the lease liability in profit or loss (applying paragraph 38(b) of IFRS 16). Accordingly, it would recognise the following amounts in profit or loss:

	Year 2	*Year 3*	*Year 4*	*Year 5*
Actual payment	100,000	100,000	104,000	104,000
Expected payment	98,000	101,500	103,600	105,000
Difference recognised in profit or loss	2,000	(1,500)	400	(1,000)

Reassessment of future variable lease payments

A11. Seller-lessee would not remeasure the lease liability to reflect any reassessment of future variable lease payments.

[7] All amounts in CU

Amounts recognised in profit or loss

A12. The following table summarises amounts Seller-lessee recognises in profit or loss in Year 2–Year 5:

Year	*Interest expense*	*Depreciation charge*	*Variable lease expense*
2	13,100	50,000	2,000
3	10,100	50,000	(1,500)
4	6,900	50,000	400
5	3,250	50,000	(1,000)