STAFF PAPER

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IASB Meeting

Project	**Lease Liability in a Sale and Leaseback**
Paper topic	Sweep issue—Measuring the ROU asset and lease liability

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Introduction and purpose of this paper

1. IFRS 16 *Leases* addresses the accounting for sale and leaseback transactions at the date of the transaction but includes no specific subsequent measurement requirements for those transactions. At its April 2020 meeting, the International Accounting Standards Board (Board) tentatively decided to propose a narrow-scope amendment to IFRS 16 to add subsequent measurement requirements for sale and leaseback transactions.

2. The proposed amendment would:

   (a) specify how a seller-lessee applies the subsequent measurement requirements in paragraphs 36–38 of IFRS 16 to the lease liability that arises in a sale and leaseback transaction.

   (b) provide an example illustrating how a seller-lessee accounts for a sale and leaseback transaction with variable lease payments, both at the date of the transaction and subsequently throughout the lease term.

   (c) require seller-lessees to apply the proposed amendment retrospectively. However, if retrospective application to lease modifications and changes in lease term would be possible only with the use of hindsight, seller-lessees would apply the proposed amendment at the date of initial application (the beginning of the annual reporting period in which the seller-lessee first applies the amendment).

3. The Board confirmed at its May 2020 meeting that it is satisfied that it has (a) complied with the applicable due process requirements and (b) undertaken sufficient consultation and analysis to begin balloting the proposed amendment.

4. The purpose of this paper is to consider a sweep issue related to how a seller-lessee initially measures the right-of-use (ROU) asset and lease liability arising from the leaseback and, consequently, applies the subsequent measurement requirements in paragraphs 36–38 of IFRS 16 to that lease liability. Based on comments received during the balloting process, we have identified what we view as a better and more understandable way to achieve the Board's objective for this project than was the case applying the Board's tentative decisions.

Structure of this paper

5. This paper is structured as follows:

   (a) Board's tentative decisions with respect to how a seller-lessee applies paragraphs 36–38 of IFRS 16 (paragraphs 6-9);

   (b) Concerns raised (paragraphs 10-16);

   (c) Alternative approaches and staff analysis (paragraphs 17-30);

   (d) Transition (paragraphs 31-34);

   (e) Staff recommendations (paragraphs 35-36);

   (f) Question for the Board; and

   (g) Appendix A—Paragraph BC266 of IFRS 16.

Board's tentative decisions with respect to how a seller-lessee applies paragraphs 36–38 of IFRS 16

6. In developing the subsequent measurement requirements for a sale and leaseback transaction, the Board viewed it as important that any requirements proposed would prevent a seller-lessee from recognising additional amounts of gain or loss on the sale of the asset beyond that recognised at the date of the transaction. This is because the recognition of any additional gain or loss would:

(a) contradict the Board's objective and rationale in developing the sale and leaseback requirements in paragraph 100(a) of IFRS 16 (see paragraph BC266 of IFRS 16 reproduced in the Appendix to this paper); and

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

7. Consequently, the Board's tentative decisions would ensure that the subsequent measurement of the lease liability that arises in a sale and leaseback transaction is consistent with its initial measurement—that is, the subsequent measurement of that liability would be expected to reflect *all* payments for the lease regardless of whether those payments meet the definition of lease payments in IFRS 16.

8. The Board tentatively decided to specify that in subsequently measuring the lease liability that arises in a sale and leaseback transaction, the seller-lessee would:

(a) increase the carrying amount to reflect interest on the lease liability using the discount rate in paragraph 37 of IFRS 16.

(b) reduce the carrying amount to reflect *payments included in the measurement of the lease liability*. Payments included in the measurement of the lease liability would be those that, when discounted using the discount rate in paragraph 37 of IFRS 16, result in an amount equal to the carrying amount of the lease liability.

(c) remeasure the carrying amount as required by paragraph 36(c) of IFRS 16; however, the seller-lessee would not remeasure the carrying amount to reflect any reassessment of variable lease payments. When applying paragraphs 40 and 45 of IFRS 16 to lease modifications and changes in lease term, the revised lease payments (described in paragraphs 40 and 45) would be the revised expected payments for the lease.

(d) recognise in profit or loss any difference between payments made for the lease and payments included in the measurement of the lease liability.

9. The proposed amendment would apply to all sale and leaseback transactions. However, the proposed amendment would be expected to affect only sale and leaseback transactions that include variable lease payments.

Concerns raised

10. Paragraph 100(a) of IFRS 16 requires a 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 it retains. The initial measurement of the lease liability is a consequence of how the ROU asset is measured—and the gain or loss on the sale and leaseback transaction determined—applying paragraph 100(a). However, IFRS 16 does not prescribe a specific method for determining the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee and, consequently, does not prescribe a method for determining the initial measurement of the ROU asset and lease liability arising from the leaseback.

11. The Board therefore decided to propose an approach for subsequent measurement of the lease liability that would work with all possible methods of determining its initial measurement. The tentative proposed approach would require a seller-lessee to determine the *payments included in the measurement of the lease liability* as those that, when discounted applying paragraph 37 of IFRS 16—that is, discounted using the interest rate implicit in the lease (if that rate can be readily determined) or the seller-lessee's incremental borrowing rate—result in the carrying amount of the lease liability. In other words, at the date of the transaction, the tentative proposed approach (a) starts with the initial measurement of the lease liability as determined applying paragraph 100(a) of IFRS 16 (based on the seller-lessee's chosen method for determining the proportion of the asset sold that relates to the right of use it retains); (b) specifies the discount rate to be used in subsequent measurement as either the interest rate implicit in the lease (if it can be readily determined) or the incremental borrowing rate; and then (c) requires the seller-lessee to impute the payments included in the measurement of the lease liability.

12. To explain the tentative proposed approach further, consider the following example:

> Seller-lessee enters into a sale and leaseback transaction whereby it transfers an asset to Buyer-lessor, and leases that asset back for 5 years. The carrying amount of the asset 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 are fixed with annual payments of CU100,000.

At the date of the transaction, Seller-lessee determines that the fair value of the right of use it retains is CU450,000. Seller-lessee's incremental borrowing rate is 3.2% (the interest rate implicit in the lease cannot be readily determined) and the present value of the annual payments (5 payments of CU100,000, discounted at 3.2% per year) is CU455,367.

13. If the seller-lessee initially measures the ROU asset arising from the leaseback by comparing the fair value of the right of use it retains to the fair value of the asset sold, it would:

(a) initially measure the ROU asset at CU250,000, calculated as:

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

(b) recognise a gain on sale relating to the rights transferred to the buyer-lessor of CU600,000, calculated as:

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

(c) initially measure the lease liability at CU450,000, calculated as the initial measurement of the ROU asset (CU250,000) plus the amount of gain that relates to the right of use the seller-lessee retains (CU200,000).

14. Applying the tentative proposed approach, the seller-lessee then imputes the payments included in the initial measurement of the liability as an annual payment of CU98,821 for each of the five years of the lease—that is, assuming the same linear profile of payments as set out in the contract, CU98,821 is the annual payment that when discounted at 3.2% (the seller-lessee's incremental borrowing rate) results in CU450,000 (the carrying amount of the lease liability on initial recognition).

15. Comments on a draft of the proposed amendment indicated concerns about:

(a) *understandability:* the tentative proposed approach of imputing lease payments could be difficult to understand. If the seller-lessee determines the initial measurement of the ROU asset and lease liability using a method other than the present value of expected lease payments (discounted at the rate implicit in the lease or its incremental borrowing rate), the imputed lease payments could be different from the expected contractual payments for the lease. This situation could occur regardless of whether the payments for the lease are fixed or variable. However, such an outcome might be particularly difficult to understand in a sale and leaseback transaction with fixed lease payments. Using the example described in paragraphs 12-14, the seller-lessee would determine the imputed lease payments as annual payments of CU98,821 (even though the fixed contractual annual payments are CU100,000).

(b) *consistent application:* the tentative proposed approach of imputing lease payments could be open to structuring. For example, it would be possible for a seller-lessee to impute lease payments with a very different profile from those expected so as to achieve a desired accounting outcome. Using the example described in paragraphs 12-14, the seller-lessee could determine the imputed lease payments differently as long as the discounted amount of those payments would equal CU450,000—as an example, the seller-lessee could impute the payments as CU120,000 in each of the first three years and then CU64,443 in years 4 and 5[1]. The seller-lessee would then recognise in profit or loss the difference between the imputed annual lease payments and the fixed annual lease payments made (CU100,000). Although the Board could address this concern by specifying that the profile of imputed lease payments must reflect the profile of expected payments, this would add another layer of complexity to the tentative proposed approach.

16. Applying the tentative proposed approach, a seller-lessee could be required to account for a sale and leaseback transaction with fixed payments as though it were a transaction with some variable payments, which in our view would make the proposals difficult to understand. As discussed in paragraph 15(a), such an outcome would occur *only* if the seller-lessee initially measures the ROU asset and lease

[1] The present value of annual payments of CU120,000 for years 1-3 and annual payments of CU64,443 for years 4-5 equals CU450,000, discounted at the seller-lessee's incremental borrowing rate of 3.2%.

liability using a method other than the present value of expected lease payments (discounted at the interest rate implicit in the lease or the seller-lessee's incremental borrowing rate)—and we would expect a seller-lessee to very often use the present value of expected lease payments. Nonetheless, the possibility of such an outcome complicates the proposals in a way that some may view as illogical. In addition, the difference in the profile of imputed payments that would be possible could create structuring opportunities that might result in inconsistent application of the requirements—this would reduce the benefits of the proposed amendment for users of financial statements. For these reasons, we have considered how the tentative proposed approach could be improved.

Alternative approaches and staff analysis

17. As discussed above, the tentative proposed approach ensures the proposed amendment works regardless of the method used by the seller-lessee to initially measure the ROU asset and lease liability that arise in a sale and leaseback transaction. However, we acknowledge the concerns raised and have considered two alternative approaches to address those concerns while still achieving the objective of the proposed amendment as described in paragraphs 6-7.

18. The alternative approaches we considered are:

    (a) *Approach A:* impute the discount rate instead of the lease payments (paragraphs 19-22).

    (b) *Approach B:* specify the method to use for determining the initial measurement of the ROU asset and lease liability (paragraphs 23-29).

Approach A: Impute the discount rate instead of the lease payments

19. Approach A would require a seller-lessee to determine the expected payments for the lease at the date of the transaction and to discount those payments using a rate that would result in the carrying amount of the lease liability. In other words, at the date of the transaction, this approach would (a) start with the initial measurement of the lease liability as determined applying paragraph 100(a) of IFRS 16 (based on the seller-lessee's chosen method for determining the proportion of the asset sold that relates to

the right of use it retains); (b) specify that the payments included in that initial measurement are the expected payments for the lease (at market rates); and then (c) require the seller-lessee to impute the discount rate—that rate would then be used when subsequently measuring the lease liability.

20. To illustrate Approach A, we will use the example in paragraph 12. Seller-lessee initially measures the ROU asset by comparing the fair value of the right of use it retains to the fair value of the asset sold, and initially measures the lease liability at CU450,000 (as illustrated in paragraph 13). The seller-lessee would then determine the discount rate that, when applied to the expected annual payments for the lease of CU100,000, results in CU450,000 (the carrying amount of the lease liability on initial recognition). This discount rate is 3.62%. The seller-lessee would then apply the discount rate of 3.62% when subsequently measuring the lease liability. Applying Approach A, there would be no difference between the annual payments made for the lease (CU100,000) and the expected annual payments for the lease included in the initial measurement of the lease liability (CU100,000).

21. Approach A would limit the change in the Board's tentative decisions to only the *mechanics* of how a seller-lessee would apply the Board's tentative proposed approach; it would not change other requirements that apply to sale and leaseback transactions. This approach would also address concerns raised about:

    (a) *understandability*—in that, the expected annual payments for the lease included in the initial measurement of the lease liability would be the same as the fixed contractual annual payments for the lease, regardless of how a seller-lessee initially measures the ROU asset and lease liability.

    (b) *consistent application*—in that, the approach would not require a seller-lessee to impute lease payments, thereby eliminating the structuring opportunity described in paragraph 15(b).

22. However, Approach A raises other concerns:

    (a) the discount rate applied for purposes of subsequently measuring the lease liability may not be the same as the rate that would be determined applying paragraph 37 of IFRS 16 (ie the interest rate implicit in the lease or the seller-lessee's incremental borrowing rate)—for example, the illustration in paragraph 20 above results in an imputed discount rate of 3.62% whereas the seller-lessee's incremental borrowing rate is 3.2%.

(b) this approach would require the seller-lessee to determine the expected payments for the lease for *all* sale and leaseback transactions, even though the seller-lessee could (in theory) determine the initial measurement of the ROU asset and lease liability using another method. This approach might therefore appear to indirectly 'require' the seller-lessee to determine the initial measurement of the ROU asset and lease liability using the present value of expected lease payments, even though IFRS 16 would not specify that method.

Approach B: Specify the method to use for determining the initial measurement of the ROU asset and lease liability

23. Approach B would require a seller-lessee to initially measure the ROU asset and lease liability that arise in a sale and leaseback transaction using the present value of expected payments for the lease. That is, in applying paragraph 100(a) of IFRS 16, a seller-lessee would determine the proportion of the asset sold that relates to the right of use it retains by comparing the present value of expected payments for the lease at market rates—discounted using the interest rate implicit in the lease (if that rate can be readily determined) or the seller-lessee's incremental borrowing rate—to the fair value of the asset sold. When subsequently measuring the resulting lease liability, the seller-lessee would then reduce the carrying amount of the lease liability to reflect those expected payments for the lease.

24. To illustrate Approach B, we will again use the example in paragraph 12. The seller-lessee would initially measure the ROU asset by comparing the present value of the expected payments for the lease (at market rates)—discounted using the seller-lessee's incremental borrowing rate—to the fair value of the asset sold. The present value of annual lease payments of CU100,000, discounted at 3.2%, is CU455,367. Consequently, the seller-lessee would:

(a) initially measure the ROU asset at CU252,982, calculated as:

$$\underset{(\textit{previous carrying amount of the asset})}{\text{CU1,000,000}} \times \frac{\underset{(\textit{present value of lease payments})}{\text{CU455,367}}}{\underset{(\textit{fair value of the asset})}{\text{CU1,800,000}}}$$

(b) recognise a gain on sale relating to the rights transferred to the buyer-lessor of CU597,615, calculated as:

$$\underset{(\textit{total gain on sale of the asset})}{\text{CU800,000}} \times \frac{\underset{(\textit{value of the rights transferred to the buyer-lessor})}{\text{CU1,800,000 - CU455,367}}}{\underset{(\textit{fair value of the asset})}{\text{CU1,800,000}}}$$

(c) initially measure the lease liability at CU455,367, calculated as the initial measurement of the ROU asset (CU252,982) plus the amount of gain that relates to the right of use the seller-lessee retains (CU202,385).

25. When subsequently measuring that lease liability, the seller-lessee would reduce the carrying amount each year to reflect the expected payments for the lease included in the initial measurement of the lease liability (CU100,000) and determine interest on the lease liability applying the seller-lessee’s incremental borrowing rate of 3.2%. Applying Approach B, there would be no difference between the annual payments made for the lease (CU100,000) and the expected annual payments for the lease included in the initial measurement of the lease liability (CU100,000).

26. If the Board were to adopt Approach B, some might question whether seller-lessees would be able to reasonably estimate the expected payments for the lease (at market rates) for *all* sale and leaseback transactions, including those that include variable lease payments. For standalone leases, a lessee excludes from the measurement of the lease liability variable lease payments linked to future performance or use of the leased asset—in reaching this decision, the Board had noted concerns about the high level of measurement uncertainty that might result from including such variable payments in the measurement of the lease liability and about the cost associated with such estimates because of the high volume of leases held by some lessees.

27. In our view, seller-lessees would be able to reasonably estimate the expected payments for the lease (at market rates) for all sale and leaseback transactions because seller-lessees are generally in a very different position to lessees that enter into standalone leases. This is because:

(a) a seller-lessee owns and controls the underlying asset until the sale and leaseback transaction. A seller-lessee would therefore be expected to have access to information that would enable them to reliably estimate the fair value of the underlying asset sold and the expected payments for the lease. In particular, because sale and leaseback transactions are often for high-value assets and are often highly-structured transactions, we would expect seller-lessees to have that information in assessing whether to enter into the transaction and the price at which to enter into it.

(b) paragraph 101 of IFRS 16 already requires a seller-lessee to consider whether the payments for the lease are at market rates and whether the fair value of the consideration equals the fair value of the underlying asset.

(c) seller-lessees generally do not have (and are not expected to have) high volumes of sale and leaseback transactions with variable lease payments.

28. Approach B would address concerns raised about:

(a) *understandability*— in that, the expected annual payments for the lease included in the initial measurement of the lease liability would be the same as the fixed contractual annual payments for the lease. Irrespective of the approach that the Board adopts, we think a seller-lessee would have to determine the expected payments for the lease in subsequently measuring the lease liability. However, if the Board adopts Approach B, in our view the proposed amendment would be simpler to draft and therefore easier for stakeholders to understand than both the tentative proposed approach and Approach A discussed above.

(b) *consistent application*—in that, this approach would not require a seller-lessee to impute lease payments, thereby eliminating the structuring opportunity described in paragraph 15(b). In addition, this approach would remove possible differences in the method a seller-lessee uses to initially measure the ROU asset and lease liability arising from the leaseback. This would facilitate greater consistency in the application of the sale and leaseback requirements when compared to both the tentative proposed approach and Approach A discussed above.

29. Approach B would however expand the initial scope of the project. That is, in addition to addressing subsequent measurement, this approach would also address the initial measurement of the ROU asset and lease liability that arise in a sale and leaseback transaction. Nonetheless, we note that the approach is consistent with the Board's objective for the proposed amendment and retains the Board's objective and rationale when it developed the sale and leaseback requirements in IFRS 16.

Conclusion

30. In the light of the analysis above, in our view Approach B—specifying the method to use for determining the initial measurement of the ROU asset and lease liability that arise in a sale and leaseback transaction—represents the most effective way to address concerns raised about the tentative proposed approach.

Transition

Board's tentative decision

31. The Board tentatively decided to require seller-lessees to apply the proposed amendment retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, if retrospective application to lease modifications and changes in lease term would be possible only with the use of hindsight, seller-lessees would apply the proposed amendment at the date of initial application (the beginning of the annual reporting period in which the seller-lessee first applies the amendment). Applying this relief, seller-lessees would determine the expected payments for the lease at the beginning of the annual reporting period in which it first applies the proposed amendment.

Effect of adopting Approach B

32. If the Board were to adopt Approach B, we think it would need to update its tentative decision about transition.

33. We continue to expect seller-lessees to be able to apply the proposed amendment retrospectively to most sale and leaseback transactions because:

(a) the proposed amendment would apply only to sale and leaseback transactions that occur after an entity's date of transition to IFRS 16. So, for most entities, this means that it would apply only to sale and leaseback transactions occurring from 2019.

(b) many sale and leaseback transactions are likely to include only fixed lease payments, and not variable lease payments.

34. However, for sale and leaseback transactions occurring since 2019 that (a) include any significant amount of variable lease payments and (b) for which the ROU asset and lease liability were initially measured using a method other than Approach B, the seller-lessee may be unable to apply the proposed amendment retrospectively without the use of hindsight. This is because retrospective application could require such seller-lessees to estimate the expected payments for the lease at the date of the transaction. For this reason, we would propose to expand the transition relief to also capture the initial measurement of sale and leaseback transactions that include variable lease payments. In that case, if retrospective application of the proposed amendment were possible only with the use of hindsight, the seller-lessee would determine the expected payments for the lease at the beginning of the annual reporting period in which it first applies the amendment.

Staff recommendations

35. Based on our analysis in this paper, we recommend that the Board:

(a) specify that when applying paragraph 100(a) of IFRS 16 to initially measure the right-of-use asset and lease liability arising from the leaseback, a seller-lessee determines the proportion of the asset sold that relates to the right of use it retains by comparing the present value of the expected payments for the lease at market rates—discounted using the interest rate implicit in the lease (if that rate can be readily determined) or the seller-lessee's incremental borrowing rate—to the fair value of the asset sold.

(b) modify its tentative proposed approach for how a seller-lessee subsequently measures the lease liability arising from the leaseback such that the seller-lessee would reduce the carrying amount of the lease liability to reflect expected payments for the lease at market rates.

(c) specify that a seller-lessee would apply the proposed amendment to IFRS 16 retrospectively in accordance with IAS 8, except when that application to sale and leaseback transactions with variable lease payments is possible only with the use of hindsight. In that case, the seller-lessee would determine the expected payments for the lease at the beginning of the annual reporting period in which it first applies the proposed amendment.

36. We note that our recommendation would not change:

(a) other aspects of the Board’s tentative proposed approach for how a seller-lessee applies paragraphs 36–38 of IFRS 16, as outlined in paragraphs 8(a), 8(c)-8(d).

(b) the Board’s tentative decision about developing an illustrative example (see paragraph 2(b)).

Question for the Board

Question for the Board
Does the Board agree with the staff recommendation in paragraph 35?

Appendix A—Paragraph BC266 of IFRS 16

A1. Paragraph BC266 explains the rationale for the Board's decisions in developing the requirements for sale and leaseback transactions in paragraph 100(a) of IFRS 16—it states (emphasis added):

> 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*.