Sale and Leaseback with Variable Payments
Issues Paper

Objective

1 To provide EFRAG TEG with an update on the IASB project and collect member's initial views and comments on the expected amendments.

Background

2 At its April 2020 meeting, the IASB tentatively decided to propose narrow-scope amendments to IFRS 16 to specify how a seller-lessee would apply the subsequent measurement requirements in IFRS 16 to a lease liability that arises in a sale and leaseback transaction with variable lease payments (not based on an index or rate). The issue was referred to the IASB by the IFRS Interpretation Committee (IFRS IC) in March 2020.

Original submission to the IFRS IC

3 The original submission received by the IFRS IC regarded the case of an entity (seller-lessee) entering into a sale and leaseback transaction whereby it transfers the asset to another entity (buyer-lessor) and leases back the asset for ten years with only variable lease payments based on a percentage of the seller-lessee's revenue derived from that asset.

4 The transfer satisfies the requirements of IFRS 15 to be accounted for as a sale of an asset. The submitter asked how the seller-lessee measures the right-of-use asset arising from the leaseback (the amount of the right-of-use asset would determine the amount of gain or loss recognised at the date of the transaction), whether it is:

(a) zero because of variable lease payments not based on an index or rate, based on measurement requirements of IFRS 16 paragraph 24, or

(b) proportion of the asset's previous carrying amount, based on requirements in paragraph 100 of IFRS 16.

5 The IFRS IC finalised its agenda decision at its 17 June meeting in which it 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.

6 More particularly: paragraph 100 of IFRS 16 applied to the transaction and consequently:

(a) To measure the right-of-use asset arising from the leaseback, the seller-lessee determines the proportion of the property, plant and equipment (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.

(b) 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.

(c) The seller-lessee also recognises a liability at the date of the transaction, corresponding to the present value of the expected payments under the lease discounted at the rate implicit in the contract (or the entity's incremental borrowing rate if the former is not determinable), even if all the payments for the lease are variable and do not depend on an index or rate. The initial measurement of the 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. See illustrative example in Appendix 1.

Issues referred by the IFRS IC to the IASB for standard-setting

7 The IFRS IC also noted that IFRS 16 was not explicit as to the subsequent measurement of the lease liability.

8 Paragraphs 36-38 of IFRS 16 describe how a lessee shall subsequently measure a **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.

9 However, paragraphs 36-38 of IFRS 16were drafted without contemplating the situation in which the measurement of the lease liability might include payments that do not meet the definition of lease payments. The sales and leaseback transaction considered provides an example of such a situation-insofar as the payments for the lease comprise only variable lease payments linked to the seller lessee's revenue and therefore do not meet IFRS 16's definition of lease payments.

10 Therefore, the IFRS IC referred the matter to the IASB, in March 2020, and recommended to revise IFRS 16 to specify how a seller-lessee applies the subsequent measurement requirements in IFRS 16 to the liability that arises in such a transaction.

Proposed amendments

11 At its April 2020 meeting, the IASB discussed the recommendation from the IFRS IC and tentatively agreed to propose a narrow-scope amendment to IFRS 16 to specify the subsequent measurement requirements in IFRS 16 to the liability that arises in in the considered transaction.

12 The proposed amendments suggest applying the requirements in paragraphs 36-38 of IFRS 16 to the payments in the leaseback transaction as follows:

(a) To consider that the 'lease payments' are the variable payments that were assessed in the original measurement of the liability recognised at the date of transaction. These payments are those that, when discounted with the discount rate used, result in an amount equal to the carrying amount of the liability.

(b) To compute the periodic interest charge using the discount rate used in the original measurement of the liability and increase accordingly the carrying amount of the liability to reflect that interest.

(c) To decrease that carrying amount to reflect the 'lease payments' made as referred to in 12(a)above.

(d) **Not to remeasure the lease liability to reflect any reassessment of future variable lease payments.** Instead any difference between the actual variable payments made and those what were expected in the initial measurement of the lease liability are charged to profit or loss when incurred (in agreement with paragraph 38 of IFRS 16).

(e) In case of lease modifications, a seller-lessee should account for that modification, applying paragraphs 40 and 45 of IFRS 16, 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.

13 The IASB also tentatively decided to develop an additional illustrative example that would illustrate how a seller-lessee would account for a sale and leaseback transaction with variable payments, both at the date of the transaction and subsequently throughout the lease term (see elements of the example discussed by the IASB at the public meeting in Appendix to this paper).

14 Lastly at is May 2020 meeting, the IASB also tentatively decided:

(a) To require a seller-lessee to apply the proposed amendment retrospectively in accordance with IAS 8 (except if possible, only without the use of hindsight);

(b) To permit a seller-lessee to early apply the proposed amendment before the effective date; and

(c) To allow a comment period of no less than 120 days for the exposure draft.

15 At that meeting the IASB granted permission to start balloting process for the Amendments. **The ED is expected to be issued in September 2020.**

16 Appendix 2 to this paper contains the relevant paragraphs of IFRS 16

EFRAG Secretariat preliminary analysis

17 The EFRAG Secretariat observes that the proposed amendments would result in no change to the underlying principles or existing requirements in IFRS 16 applicable to the accounting for a 'standalone' lease (that is a lease entered into outside of a sale and leaseback transaction).

18 Instead, the Amendments explain how to apply existing principles to lease arising in the context of sale and leaseback transactions that have only variable payments not based on an index or rate. These principles have been assessed to result in useful information in EFRAG's endorsement advice.

19 However, there is an underlying assumption made by the IASB that the liability arising from the transactions is a lease liability under IFRS 16 (rather than, for example, a financial liability under IFRS 9). Although the EFRAG Secretariat does not necessarily disagree with the conclusion, we observe that:

(a) Mixed views were expressed on the matter by IFRS IC members when the topic was discussed. As a consequence, the IFRS IC decided to not qualify the nature of the liability in its agenda decision and leave the IASB address the matter.

(b) The IASB members themselves expressed mixed views on the matter when developing IFRS 16 as explained in the Basis for Conclusion.

BC 169 The IASB decided to exclude variable lease payments linked to future performance or use of an underlying asset from the measurement of lease liabilities. For some Board members, this decision was made solely for cost-benefit reasons. Those Board members were of the view that all variable lease payments meet the definition of a liability for the lessee. However, they were persuaded by the feedback received from stakeholders that the costs of including variable lease payments linked to future performance or use would outweigh the benefits, particularly because of the concerns expressed about the high level of measurement uncertainty that would result from including them and the high volume of leases held by some lessees.

Other Board members did not think that variable lease payments linked to future performance or use meet the definition of a liability for the lessee until the performance or use occurs. They regarded those payments to be avoidable by the lessee and, accordingly, concluded that the lessee does not have a present obligation to make those payments at the commencement date. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future economic benefits to be derived from use of the asset

20 The EFRAG Secretariat recommends that the forthcoming Exposure Draft clearly explains, in its Basis for Conclusions, the rationale for the IASB to consider that the liability arising from the considered transactions are within the scope of IFRS 16.

21 In lien with the above matter, the EFRAG Secretariat also observes that the proposed subsequent accounting for the liability assumes that the seller-lessee is always capable of reliably estimating, at the date of the transaction, its future lease payments which are based on its own estimated future revenue; and this over the whole term of the lease.

22 Again, in developing IFRS 16, the IASB acknowledged that (BC 10) '*it would be extremely difficult in many cases to estimate variable lease payments if the amounts depended on future sales or use of the underlying asset and that such estimates would be subject to a high level of measurement uncertainty*'.

23 The EFRAG Secretariat further suggest that the ED also addresses the situation whereby future payments cannot be estimated reliably and provides guidance in such circumstances.

Questions for EFRAG TEG

24 Does EFRAG TEG have comments or questions on the project summary provided, above?

25 What are you initial views on the expected amendments described in paragraphs 11 to 19?

Appendix 1: IASB staff Worked example applying the proposals

Assumptions

26 The transaction has the following characteristics

(a) 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.

(b) The transfer of the PPE satisfies the requirements in IFRS 15 to be accounted for as a sale of the PPE.

(c) The carrying amount of the PPE in Seller-lessee's financial statements at the date of the transaction is CU1,000,000,

(d) The amount paid by Buyer-lessor for the PPE is CU1,800,000 (the fair value of the PPE at that date).

(e) 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.

(f) At the date of the transaction, the Seller-lessee expects revenue generated using the PPE (and therefore expected lease payments) to be as shown in the following table.

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

(g) Seller-lessee’s incremental borrowing rate is 3.5 per cent (the interest rate implicit in the lease is not readily determinable).

(h) At the date of the transaction, the present value of the expected payments discounted at the incremental borrowing rate of 3,5% is CU450,000.

(i) There are no initial direct costs.

Accounting at the date of the Transaction

27 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).

28 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.

29 Applying paragraph 100(a), the Seller-lessee would:

(a) Derecognise the PPE of CU1,000,000

(b) Recognise a 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).

(c) Recognise 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).

(d) Recognise a (lease) liability of CU450,000 being the present value of the future expected lease payment. (see assumptions). By construction, this liability represents 25% of the selling price of CU1,800,000 received from the buyer-lessor).

30 Accordingly, 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. Liability		CU450,000
Cr. Gain on rights transferred		CU600,000

Subsequent accounting – Year 1

31 An additional assumption is that, at the end of year 1, the seller -lessee determines that the variable payment to make (based on its actual revenue for the period) is CU 92,000 instead of CU91,000 initially included in the lease liability.

32 Applying the proposals, the seller-lessee would record the following:

DR. Depreciation charge CR. Right-of-use asset	50,000	 50,000	To amortise the RoU asset: 250,000 / 5 years = 50, 000
DR. Interest expense CR. Lease liability	15,750	 15,750	To compute the periodic interest expense on the liability: 3,5% X 450,000 = 15750
DR. Lease liability DR Expense CR Cash	91,000. 1,000	 92,000	To reflect the Year 1 repayment of the liability for CU91,000 (expected lease payments' included in the initial measurement) To account any difference between expected and actual payment for Year 1 as an expense in PL

33 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).

Subsequent accounting – Year 2 to 5

34 Following the same logic as for Year 1 and assuming that the actual lease payments compare to expected ones as follows for each accounting periods:

	Year 1	Year 2	Year 3	Year 4	Year 5
Actual lease payments	92.000	100,000	100.000	104.000	104.000
Expected lease payment	91,000	98,000	101,500	103,600	105,000

35 The Seller-lessee's lease liability and right-of-use asset from Year 2 to Year 5 would be as follows:

	Lease liability				**Right-of-Use Asset**		
Year	**Beginning balance**	**Expected payment 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	**0**	50.000	(50,000)	**0**

36 In addition to the above the 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 lease payments	100,000	100.000	104.000	104.000
Expected lease payment	98,000	101,500	103,600	105,000
Difference recognised in PL over the periods (+ = profit; - = loss)	(2,000)	1500	(400)	1,000

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

Appendix 2: Relevant sections of IFRS 16

Subsequent measurement

1 **Paragraphs 36–38 of IFRS 16** state the following:

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.

Sale and leaseback transactions

2 **Paragraphs 98-103 of IFRS 16** state the following:

98 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.

Assessing whether the transfer of the asset is a sale

99 An entity shall apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset.

Transfer of the asset is a sale

100 If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS15 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.

(b) the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in this Standard.

101 If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an *entity shall make the following adjustments to measure the sale proceeds at fair* value:

(a) any below-market terms shall be accounted for as a prepayment of lease payments; and

(b) any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

102 The entity shall measure any potential adjustment required by paragraph 101 on the basis of the more readily determinable of:

(a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and

(b) the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

Transfer of the asset is not a sale

103 If the transfer of an asset by the seller-lessee does not satisfy the requirements of IFRS 15 to be accounted for as a sale of the asset:

(a) the seller-lessee shall continue to recognise the transferred asset and shall recognise a financial liability equal to the transfer proceeds. It shall account for the financial liability applying IFRS 9.

(b) the buyer-lessor shall not recognise the transferred asset and shall recognise a financial asset equal to the transfer proceeds. It shall account for the financial asset applying IFRS 9.

Lease Modifications

3 **Paragraphs 44-46 of IFRS 16** state the following:

44 A lessee shall account for a lease modification as a separate lease if both:

(a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and

(b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

45 For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification a lessee shall:

(a) allocate the consideration in the modified contract applying paragraphs 13–16;

(b) determine the lease term of the modified lease applying paragraphs 18–19;

(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate.

The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

46 For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:

(a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.

(b) making a corresponding adjustment to the right-of-use asset for all other lease modifications.