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## Lease Liability in a Sale and Leaseback Project Update

### Objective

- 1 The objective of the session is to provide to EFRAG FR Board an update on the project and to discuss the approval process for the EFRAG's Draft Endorsement Advice (DEA).

### Background

- 2 On 22<sup>nd</sup> September 2022 the IASB published the Amendments to IFRS 16 Lease Liability in a Sale and Leaseback, (the 'Amendments'), which are applicable for annual reporting periods beginning on or after 1 January 2024, with earlier application allowed. One member voted against the Amendments.
- 3 The Amendments address an issue raised by the IFRS Interpretations Committee regarding the accounting by seller-lessees of sale and leaseback transaction (SLB) where the leaseback include variable payments not based on an index or rate (e.g., variable payments based on performance or use of the leased assets). The issue is at the crossroads of two possibly conflicting principles in IFRS 16:
  - (a) Under IFRS 16, variable lease payments not based on an index or rate are not capitalised but expensed as incurred; and
  - (b) IFRS 16 prescribes in a SLB gains should only be recognised in proportion of the rights transferred to the buyer-lessor not the rights retained through the leaseback. Recognising no liability (or a zero liability) for the leaseback would result in a full gain recognition.
- 4 At its February 2022 meeting, the IASB confirmed that the Proposed Amendments did not require re-exposure and confirmed mainly the approach included in the exposure-draft.
- 5 Applying the Amendments, a seller lessee shall:
  - a) initially measure the right-of-use (ROU) asset arising from a leaseback at the proportion of the previous carrying amount of the asset that relates to the ROU retained by the seller-lessee.
  - b) recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

- c) recognise a leaseback liability (as a consequence of the above) and apply the existing IFRS 16 requirements to subsequently measure the lease liability (i.e., lease payments are allocated between repayment of principal and payment of interests).
- 6 IFRS 16 does not prescribe how the proportion of rights transferred and retained should be calculated. The IASB identifies two possible approaches ("expected lease payments approach" and "equal lease payments approach") which are illustrated in the example 25 of the Amendments.
- 7 The European Commission issued a letter requesting advice on the endorsement of the Amendments from EFRAG on 27th September 2022. The letter contains a standard request for advice on the endorsement that does not identify specific issues or areas to investigate. EFRAG is asked to carry out an assessment of the Amendments against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and is also assessing the costs and benefits that would arise from its implementation in the European Union (the EU) and European Economic Area.

### **EFRAG's previous discussions and views**

- 8 In its April 2021 Final Comment Letter issued in response to the exposure-draft, EFRAG considered that the proposed amendments provided evidence of a broader conflict of principles in IFRS 16 regarding the accounting for sale and leaseback transactions and the definition of lease payments. EFRAG therefore encouraged the IASB to consider the issue more comprehensively and in a timely manner, possibly as part of the upcoming Post-Implementation review of IFRS 16 or the IASB's project on Variable and Contingent Consideration.
- 9 EFRAG could accept that a temporary and faster solution to address the lack of guidance in IFRS 16, pending a more holistic review of the matter. However, EFRAG encourages the IASB to consider a simplified solution by recognising the profit attributable to the retained interest in the right-of-use asset as a non-lease liability or deferred income rather than a lease liability.
- 10 EFRAG views in the comment letter were consistent with the views expressed when endorsing IFRS 16 that variable payments do not qualify for recognition as lease liability.
- 11 At their March and June 2022 meetings, EFRAG FR TEG and CFSS received an update on the IASB's tentative decisions on this project and a presentation of the differences between these decisions and EFRAG's recommendations as expressed in its Comment Letter.
- 12 Members noted and regretted that the IASB considered but had not followed the main suggestion made by EFRAG and many EU National Standard Setters to recognise a non-lease liability or deferred income rather than a lease liability, to avoid introducing two different definitions of lease payments.
- 13 EFRAG FR TEG and CFSS members noted that one of the important elements for EFRAG's evaluation for the endorsement was the assessment of the prevalence of the types of transactions covered by the Amendments in the EU. Some noted that the type of transactions covered by the proposed Amendments were not prevalent in their jurisdictions. Others noted that despite not being prevalent lease-back transactions are often individually significant. Some suggested that input about the prevalence of such transactions in the EU should be sought after by reaching out to some industries such as real-estate, hospitality and retail industry.

### **Prevalence of transactions covered by the Amendments in the EU**

- 14 The EFRAG Secretariat has performed the following activities:
  - (a) request for information to EFRAG CFSS members about the prevalence and volume of such transactions;
  - (b) discussion with large audit firms (involving their IFRS 16 specialists);
  - (c) reach out to industries where such transactions might have occurred (directly or through EFRAG's members organisations such as European issuers and BusinessEurope) including the real-estate, hospitality and retail sector.
- 15 To obtain further evidence about the prevalence, volume and materiality of sale and leaseback transactions with variable payments, we have also used the search engine AlphaSense, to identify such transactions. We performed the search in early October 2022 and considered the period since the first application of IFRS 16 (January 2019). The search considered entities' interim or annual financial statements, circulars, integrated reports, merger and acquisition-related documents, and prospectuses. The search was done for various forms of 'sale and leaseback' and 'variable payments' and did not identify seller-lessees disclosing material sale and leaseback transactions for which the leaseback payments are based on performance or usage of the underlying asset.
- 16 Overall, the findings from these different activities have provided evidence for the following:
  - (a) SLB transactions in general have been less frequent in recent periods since the first application of IFRS 16 in 2019, likely on account of less favourable economic conditions for such transactions (low interest rate environment, pandemic etc);
  - (b) SLB with variable lease payments not based on an index or rate did occur in the past but have not been frequent. Only very few examples (mostly outside the EU) have been identified in the hospitality or utility sector. When they have occurred, such transactions could involve material amounts;
  - (c) Leases of assets with variable payments not based on an index or rate are themselves increasingly to be observed in some sectors (e.g. renewable energies), which in turn could provide a basis for more sale and leaseback of such assets in the future. It is however difficult to make predictions and that would depend on a number of factors, including the future economic conditions.

#### **Work plan for EFRAG's Draft and Final Endorsement Advice**

- 17 EFRAG FR TEG will discuss the DEA prepared by the EFRAG Secretariat at its 3 November 2022 meeting. This project has been identified as 'significant' by EFRAG FRB and was discussed in previous FRB meetings. Accordingly, going back to written procedure for the EFRAG FRB's approval on the Draft Endorsement Advice requires a decision by FRB.
- 18 Based on the evidence collected that the type of transactions covered by the Amendments are not predominant in Europe so far and the vague possibility that transactions might increase in the future, the endorsement of this Amendment would not raise particular challenges.
- 19 As the EFRAG FRB has no meeting scheduled from end of October to the 21<sup>st</sup> of December, the EFRAG Secretariat would like to ask the EFRAG FRB whether they agree to approve the DEA and the FEA through written procedures.
- 20 If the EFRAG FRB disagrees with approving the DEA by written consultation an additional EFRAG FRB meeting should be scheduled, in mid or end-November 2022.

- 21 The timetable for the project, assuming a written procedure is applied, would be as follows:

EFRAG FR TEG approval of DEA to recommend to the EFRAG FRB	3 November 2022
Written consultation of EFRAG FRB on the DEA	4-9 November 2022
Public consultation on DEA	10 November to 9 January 2023 (2 months)
EFRAG FR TEG approval of Final Endorsement Advice (FEA) to recommend to the EFRAG FRB	19 January 2023
Written consultation of EFRAG FRB on the FEA (Alternatively, discussion of the topic in the FRB meeting in February 2023)	Week 23 January 2023
Publication of the Final Endorsement Advice	30 January 2023

**Questions for EFRAG FRB members**

- 22 Does EFRAG FRB agree following a written procedure for the adaption of the DEA as suggested in paragraph 17?
- 23 Regarding the FEA, does the EFRAG FRB also agree to a written procedure, or do you want to discuss the topic in a meeting in February 2023?
- 24 Do EFRAG FRB members have other questions on the project update?