

Project Update—*Lease Liability in a Sale and Leaseback* (Forthcoming Amendment to IFRS 16 Leases)

Executive Summary

Project type	Endorsement and adoption
Project scope	Narrow-scope
Purpose of the paper	
<p>This paper provides the Board with an update on the forthcoming Amendment to IFRS 16: <i>Lease Liability in a Sale and Leaseback</i> (the Amendment).</p> <p>At the time of writing, the IASB is expected to publish the Amendment by the end of September 2022 with an effective date of 1 January 2024, with earlier application permitted.</p>	
Summary of the issue	
<p>The objective of the Amendment is to add requirements in IFRS 16 on how to subsequently measure the leaseback liability in a sale and leaseback transaction that includes variable leaseback payments that do not depend on an index or rate (i.e. variable lease payments linked to future performance or use of an underlying asset).</p> <p>The project originated from a submission to the IFRS Interpretations Committee (the Committee) about a sale and leaseback transaction that includes variable lease payments that depend on the seller-lessee's revenue generated using the underlying asset. The Committee concluded that IFRS 16 provides an adequate basis for determining the accounting for the sale and leaseback at the date of the transaction. However, IFRS 16 includes no specific subsequent measurement requirements for sale and leaseback transactions and the Committee recommended standard-setting to add such requirements to IFRS 16.</p>	
Decisions for the Board	
<p>The Board is not asked to make any decisions. However, Board members are asked for any questions or comments on the update provided in this paper.</p>	
Recommendation	
N/A	
Appendices	
None	

Purpose

1. This paper provides an update on *Lease Liability in a Sale and Leaseback*, the IASB's forthcoming amendment to IFRS 16 *Leases* (the Amendment). It includes background information on the Exposure Draft (ED) proposals and on the UKEB Final Comment Letter (FCL), and provides an update on the IASB's subsequent redeliberations. The Board is not asked to make any decisions, but the paper seeks the Board's views on the tentative decisions reached by the IASB.

Project history

2. The IFRS Interpretations Committee (the Committee) received a request about the application of paragraph 100(a) of IFRS 16 to a sale and leaseback transaction that includes variable lease payments that do not depend on an index or rate.
3. The Committee concluded that IFRS 16 provides an adequate basis for determining the accounting for the sale and leaseback at the date of the transaction. However, the Committee observed that IFRS 16 does not include specific requirements for the subsequent measurement of sale and leaseback transactions. The Committee referred this issue to the IASB and the Amendment is the outcome of the IASB's standard-setting project to fill the gap in IFRS 16.
4. The UKEB Secretariat submitted its FCL on the ED to the IASB on 26 March 2021¹ before the Board's Statutory Functions had been delegated by the Secretary of State². The Board was therefore not involved in this work on the FCL. This paper therefore includes background information on IFRS 16's requirements and on the proposals in the ED to provide a fuller context for this update.

Background

Existing IFRS 16 measurement requirements:

Initial measurement—right-of-use (ROU) asset

5. Under IFRS 16 the leased asset, referred to as the right-of-use (ROU) asset, is measured at cost at the commencement date. Cost comprises the following components (**emphasis added**)³:
 - a) the amount of the **initial measurement of the lease liability** (see below);

¹ [Final Comment Letter - Lease Liability in a Sale and Leaseback \(Proposed amendment to IFRS 16\).pdf \(kc-usercontent.com\)](#)

² The Statutory Functions were delegated by the Secretary of State to the UKEB on 22 May 2021.

³ IFRS 16 paragraphs 23 and 24.

- b) any lease payments made at or before the commencement date, less any *lease incentives* received;
 - c) any *initial direct costs* incurred by the lessee; and
 - d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.
6. The initial measurement of the ROU asset is therefore a consequence of how the lease liability is measured.

Initial measurement—lease liability⁴

7. The lease liability is initially measured at the present value of the future lease payments.
8. 'Lease payments' is defined in Appendix A to IFRS 16 as **(emphasis added)**:

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; and*
- (d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.*

9. In addition, variable lease payments are defined in IFRS 16 Appendix A as:

The portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

10. The variability arises if lease payments are linked to⁵:
- a) Price changes due to changes in a market rate or the value of an index. For example, lease payments might be adjusted for changes in a benchmark interest rate or a consumer price index.

⁴ IFRS 16 paragraphs 27-28.

⁵ IFRS 16 Basis for Conclusions paragraph BC163. Items b) and c) are the focus of the Amendment.

- b) The lessee's performance derived from the underlying asset. For example, a lease of retail property may specify that lease payments are based on a specified percentage of sales made from that property.
 - c) The use of the underlying asset. For example, a vehicle lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.
11. As noted in paragraph 8 above, variable payments that do not depend on an index or rate (i.e. those linked to future performance or use of an underlying asset) are excluded from the measurement of lease liabilities.
12. Paragraphs BC168 and BC169 of the Basis of Conclusions to IFRS 16 explain the IASB's discussion on this matter. In summary, there were mixed views about whether variable lease payments linked to future performance or use of an underlying asset meet the definition of a liability. Further, there were concerns about the high level of measurement uncertainty that would result from including them and the high volume of leases held by some lessees. Consequently, the IASB decided to exclude such variable lease payments from the measurement of lease liabilities.

Subsequent measurement—lease liability

13. After the commencement date, the lease liability should be measured by⁶:
- 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 IFRS 16 paragraphs 39–46, or to reflect revised in-substance fixed lease payments.
14. After the commencement date, a lessee should recognise in profit or loss⁷ 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.

⁶ IFRS 16 paragraph 36.

⁷ Unless the costs are included in the carrying amount of another asset applying other applicable IFRS Accounting Standards.

Accounting for sale and leasebacks under IFRS 16

15. The accounting requirements in respect of sale and leaseback transactions are set out in paragraphs 98 to 103 of IFRS 16. For the purposes of the Amendment, the key paragraph is IFRS 16 paragraph 100 (a) which states:

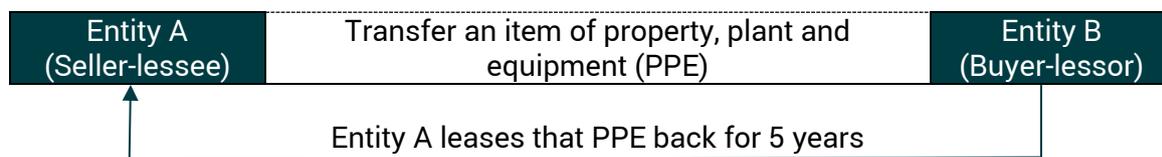
the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

16. The Committee received a request related to a sale and leaseback transaction that includes variable lease payments that do not depend on an index or rate. The request asked how the seller-lessee should measure the ROU asset arising from the leaseback and, thus, determine any gain or loss to be recognised at the date of the transaction.
17. The Committee observed that IFRS 16 does not prescribe a method for determining the proportion of the asset that is retained. However, the Committee described one possible method of determining the proportion⁸ and provided an example to illustrate the accounting. **The Committee noted that, for a sale and leaseback, the initial measurement of the liability is a consequence of how the ROU asset is measured⁹ and of how the gain or loss on the transaction is determined.** This means that the initial liability includes all lease payments, including any that are variable and do not depend on an index or rate.
18. Measuring the lease liability in the same way as a liability arising from a lease unrelated to a sale and leaseback transaction (that is, excluding variable payments) could result in seller-lessees recognising gains related to the rights retained—an approach inconsistent with the economics of the transaction.
19. The following illustrative example is based on the one included in the Committee's Agenda Decision. The example explains the mechanics of the accounting requirements in IFRS 16 for the initial recognition of a sale and leaseback transaction that includes variable lease payments.

⁸ By comparing the present value of expected payments (including those that are variable) with the fair value of the asset at the transaction date.

⁹ Not the other way around – compare paragraph 6 above.

Seller-lessee accounting with Variable Payment



Details for the transfer of the PPE:
Details of leaseback

- Carrying amount in Entity A's accounts = CU1 million
- Amount paid by Entity B = CU1.8 million (FV of the PPE)
- All payments for the lease (at market rate) are variable (calculated as a % of Entity A's revenue generated using the PPE during the 5-year lease term)
- At the date of the transaction, present value (PV) of the expected payments for the lease = CU450,000.

The transfer satisfies the requirements of IFRS 15 to be accounted for as a sale.

Step 1: Measure the right-of-use (ROU) asset

The seller-lessee has sold an asset but retained a right to use it. Entity A determines that it is appropriate to calculate the proportion of the PPE that relates to the ROU retained using the PV of expected payments for the lease:

$$\frac{\text{PV of expected payments for the lease}}{\text{FV of the PPE}} = \frac{450,000}{1,800,000} = 25\%$$

ROU asset retained = 25% x 1,000,000 = CU250,000

Step 2: Identify the gain or loss on rights transferred to the buyer-lessor

Total gain on sale of PPE = 1.8 million – 1 million = CU800,000

200,000	800,000 x	Relates to the right to use the PPE retained by seller-lessee—see step 1 above for the proportion.
	25%	
600,000		Balancing figure— relates to the rights transferred to buyer-lessor
800,000		

At the date of the transaction, seller-lessee accounts for the transaction as follows.

Dr Cash	1,800,000	
Dr ROU asset	250,000	
	Cr PPE	1,000,000
	Cr Lease Liability	450,000
	Gain on rights transferred	600,000

Sale and leaseback – subsequent measurement

20. The Committee's discussions highlighted the absence of specific subsequent measurement requirements for sale and leaseback transactions in IFRS 16 and the possibility that this might lead to inconsistent treatment being applied by seller-lessees. The Committee referred this issue to the IASB.
21. In circumstances where the leaseback payments are not variable, the initial measurement of the liability would be similar to that of a lease liability unrelated to a sale and leaseback (in accordance with paragraphs 26-27 of IFRS 16). Further, the seller-lessee would apply paragraphs 36-38 of IFRS 16 for the subsequent measurement of the lease liability i.e. similar to measuring any other lease liability. In general, this should not lead to any accounting difficulties.
22. In sale and leaseback transactions involving variable lease payments, however, there is a risk that the subsequent measurement of the lease liability (in accordance with paragraphs 36-38 of IFRS 16) could be inconsistent with its initial measurement. In particular, if there were a modification in the contract or a change in lease term, the necessary remeasurement could result in the seller-lessee recognising a gain or loss on the rights retained.

Example

In the example above, although perhaps unlikely to arise in practice, all the payments for the lease are variable, calculated as a % of seller-lessee's revenue generated using the PPE during the leaseback term, that is, they do not depend on an index or rate. Now assume there is a change in the leaseback term. Applying the lease modification requirements in IFRS 16 for leases unrelated to a sale and leaseback transaction, the seller-lessee would remeasure the lease liability by discounting the revised lease payments using a revised discount rate. As noted above, 'lease payments' is a defined term in IFRS 16 and excludes from the measurement of the lease liability variable payments that do not depend on an index or rate (and that are not in-substance fixed payments). As a result, the subsequent measurement of the lease liability will be the present value of zero at the revised discount rate. The lease liability would therefore be reduced to nil with a corresponding adjustment to the right-of-use asset and a resulting gain to profit or loss.

23. The objective of the Amendment is to prevent such inconsistency between the initial recognition and the subsequent accounting for the lease liability and the consequent risk of gains or losses being recognised on the rights retained.

IASB's Exposure Draft and project timeline

24. The IASB published an ED in November 2020¹⁰ proposing a narrow scope amendment to IFRS 16 mainly to add requirements on how to subsequently measure the leaseback liability arising for sale and leaseback transactions, without changing the principles for

¹⁰ [Exposure Draft: Lease Liability in a Sale and Leaseback \(ifrs.org\)](https://www.iasb.org/Exposure-Draft-Lease-Liability-in-a-Sale-and-Leaseback)

the sale and leaseback requirements in IFRS 16 or the accounting for leases unrelated to sale and leaseback transactions.

25. The IASB received 87 comment letters on the ED and almost all respondents supported the objective of the proposed amendment which is to improve the subsequent measurement requirements for sale and leaseback transactions. The UKEB Secretariat's FCL in principle supported the proposals in the ED and noted that adding requirements on an area not covered by the existing standard should reduce any diversity of practice, enhancing consistency and comparability of financial statements.
26. The IASB discussed the feedback received on the ED at its May 2021¹¹ meeting. At its December 2021¹² meeting the IASB tentatively decided to:
- a) confirm some of the proposals in the ED; but
 - b) change some of the other amendments proposed in the ED.
27. At the time of writing, the IASB plans to publish the Amendment in Q3 of 2022.

ED proposals, UKEB comment and subsequent IASB tentative decisions

28. The table on the following pages summarises the main proposals in the ED, the UKEB Secretariat response in the FCL, and the tentative decisions reached by the IASB.

¹¹ [AP12C: Lease Liability in a Sale and Leaseback: Feedback Summary – Background and Overview \(ifrs.org\)](#)
[AP12D: Lease Liability in a Sale and Leaseback: Feedback Summary – Main Matters \(ifrs.org\)](#)
[AP12E: Lease Liability in a Sale and Leaseback: Feedback Summary – Transition and Other Matters \(ifrs.org\)](#)

¹² [AP12A: Lease Liability in a Sale and Leaseback: Project direction \(ifrs.org\)](#)

Topics	ED proposals	UKEB position in FCL to IASB ³	IASB tentative decision	IASB rationale supporting tentative decision
1. Initial measurement	To require the seller-lessee to determine the portion of the previous asset carrying amount retained for use by comparing the present value of the expected lease payments to the fair value of the asset sold.	<p>●</p> <p>We supported the proposal—the use of present value and fair value are consistent with existing requirements of IFRS 16 and familiar to preparers and users.</p>	Changes the ED proposal: now does not prescribe a method for determining the proportion of the previous carrying amount of the asset that relates to the right-of-use the seller-lessee retains.	<p>Expected lease payments could introduce a high level of measurement uncertainty.</p> <p>Practicality—other methods may be appropriate. For example, comparing the fair value of the residual interest to the full fair value.</p>
2. Expected lease payments	To specify the payments that comprise expected lease payments. In particular, expected lease payments would include variable lease payments regardless of whether they depend on an index or rate (ie variable lease payments linked to future performance or use of an underlying asset).	<p>●</p> <p>We did not support this proposal because creating a definition of lease payments inconsistent with that defined in IFRS 16 creates the risk of inconsistency in financial reporting.</p> <p>We suggested two alternate solutions to the IASB to remove this inconsistency while ensuring the gain on sale still reflected economic substance of the transaction.</p>	Changes the ED proposal to specify, for the purposes of subsequent measurement applying paragraphs 36–46, the term ‘lease payments’ may not be as defined in Appendix A to IFRS 16. Instead, the seller-lessee would apply the term ‘lease payments’ or ‘revised lease payments’ in such a manner that it does not recognise any amount of the gain or loss that relates to the right of use retained.	In response to stakeholders’ conceptual and practical concerns about the proposal, the IASB decided not to prescribe specific measurement requirements for lease liabilities arising from a leaseback. Instead, the IASB decided to address the primary issue by requiring a seller-lessee to subsequently measure lease liabilities arising from a leaseback in a way that it does not recognise any amount of the gain or loss that relates to the right of use it retains.

¹³ See the UKEB’s Feedback Statement on the ED: [Final Feedback Statement - Lease Liability in a Sale and Leaseback \(Proposed amendment to IFRS 16\).pdf \(kc-usercontent.com\)](#)

Topics	ED proposals	UKEB position in FCL to IASB ³	IASB tentative decision	IASB rationale supporting tentative decision
3. Subsequent measurement	To specify that the right-of-use asset be accounted for under paragraphs 29-35 of IFRS 16. New requirements for accounting for the lease liability are then specified which increase the liability to reflect interest, reduce the liability to reflect payments and specify the treatment for remeasurement and shortfalls.	We agreed with the proposals and noted it was helpful to have clarity on the circumstances in which a lease liability would be remeasured. ●	Retains the ED proposal by clarifying that a seller-lessee subsequently measures the right-of-use asset arising from a leaseback by applying paragraphs 29–35 of IFRS 16. Require a seller-lessee to subsequently measure the liability arising from the leaseback by applying paragraphs 36–46 of IFRS 16.	Addresses the concern that IFRS 16 includes no specific subsequent measurement requirements for sale and leaseback transactions, but does so in a manner that is not prescriptive.
4. Retrospective application	To require retrospective application except where retrospective application to a sale and leaseback transaction that includes variable payments would be possible only with the use of hindsight	We supported this proposal—IFRS 16 was only introduced in 2019 and therefore the records related to the transactions were likely to be readily available. ●	Retains the ED proposal by requiring entities to apply the amendments retrospectively in accordance with IAS 8 and provide no specific transition exemption for first-time adopters. Entities will be required to apply the amendments for annual reporting periods beginning on or after 1 January 2024, with earlier application permitted. ¹⁴	Expected benefits of retrospective application in accordance with IAS 8 would outweigh the costs.

KEY: ● Support ● Support direction but recommend clarification in drafting ● Do not support

¹⁴ [AP12C: Transition, effective date and due process \(ifrs.org\)](#)

Subsequent measurement—development of proposals

29. As noted above, for sale and leaseback transactions the initial measurement of the lease liability is a consequence of how the ROU asset is measured. In developing the ED, the IASB's approach was to require the subsequent measurement of the lease liability arising in a sale and leaseback to be consistent with its initial measurement i.e. including all payments regardless of whether they meet the definition of lease payments. This approach avoids the recognition of a gain or loss on the ROU the seller-lessee retains, consistent with the economics of the transaction as explained in paragraph BC13 of the Basis for Conclusion to the ED:

This approach would require seller-lessees to include all payments in the measurement of the lease liability, thereby avoiding the recognition of an additional gain or loss associated with the sale of the asset when no transaction or event has occurred to give rise to such a gain or loss.

30. As a result of feedback on the ED, the IASB decided not to prescribe specific measurement requirements for lease liabilities arising from a leaseback that would be different from subsequent measurement requirements for lease liabilities unrelated to a sale and leaseback transaction as proposed in the ED. Instead, the IASB decided to address the primary issue of prohibiting the recognition of a gain or loss by a seller-lessee on the right of use it retains solely because of a remeasurement. The Amendment is now expected to require the seller-lessee to apply paragraphs 36–46 of IFRS 16 (the existing requirements for subsequent measurement of the lease liability and for lease modifications) when subsequently measuring the leaseback liability. In addition, however, the amendment would explicitly state that the seller-lessee should determine 'lease payments' or 'revised lease payments' in a way that the seller-lessee would not recognise any amount of the gain or loss that relates to the right of use retained by the seller-lessee.

31. Some respondents consider that the sale and leaseback accounting requirements in IFRS 16 need more fundamental reconsideration. However, the IASB's preferred approach is to avoid a holistic reconsideration of the accounting for sale and leaseback transactions before the Post-implementation Review of IFRS 16.

Question for the Board
32. Do Board members have any questions or comments on the update provided in this paper?

Next steps

33. The Amendment is expected to be published by the end of September 2022. On that basis, we plan to present a Project Initiation Plan at the Board's November 2022 meeting.