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Lease liability in a sale and leaseback Cover Note

Objective

- 1 To discuss and agree to recommend a draft comment letter for consideration by the EFRAG Board.

Background

- 2 At its April 2020 meeting, the IASB decided to propose narrow-scope amendments to IFRS 16 to address an issue referred by the IFRS Interpretations Committee (IFRS IC) to clarify 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).
- 3 Paragraphs 36-38 of IFRS 16 describe how a lessee shall subsequently measure a lease liability. **However, these paragraphs were 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 (i.e. variable lease payments not based on an index or rate).**
- 4 Paragraph 100 of IFRS 16 requires that, if the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale of the asset, the seller-lessee measures the right-of-use ('ROU') 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. **However, IFRS 16 does not prescribe a specific method for measuring that proportion** that determines the ROU asset, the related liability and the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

Proposed amendments

- 5 The ED proposes:
 - (a) to require a seller-lessee to determine the initial measurement of the ROU asset by comparing the present value of the expected lease payments, discounted using the rate specified in paragraph 26 of IFRS 16, to the fair value of the asset sold (paragraph 100(a)(i));
 - (b) to specify the payments that comprise the expected lease payments for sale and leaseback transactions (paragraph 100A); and
 - (c) to specify how a seller-lessee subsequently measures the lease liability arising in a sale and leaseback transaction (paragraph 102B).

- 6 Applying the ED an entity would:
- (a) initially measure the right-of-use 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; and recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor;
 - (b) determine the initial measurement of the right-of-use asset and lease liability using the present value of expected lease payments (including all payments regardless of whether they meet the definition of lease payments);
 - (c) subsequently measure the lease liability consistently with its initial measurement, that is including all payments regardless of whether they meet the definition of lease payments; and apply the provisions in Paragraphs 36-38 by:
 - (i) increasing the carrying amount to reflect interest on the lease liability;
 - (ii) reducing the carrying amount to reflect the lease payments made; and
 - (iii) 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;
 - (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.

Previous discussions at EFRAG TEG

- 7 EFRAG TEG discussed the tentative agenda decisions at its July meeting. At the time, the tentative decisions made by the IASB only addressed the subsequent measurement of the lease liability.
- 8 Most EFRAG TEG members supported the IASB's proposals as they addressed an area where guidance was missing in IFRS 16. Some members noted the following operational challenges that could arise from the Amendments:
- (a) Calculating the gain on the sale of the asset at the date of transaction; and
 - (b) Estimating the future sales on which lease payments were based under the contract for longer periods.
 - (c) Some EFRAG TEG members noted the interactions between IFRS 9 *Financial Instruments* and IFRS 16 for the liability.

Tentative decisions taken after the TEG discussion in July

- 9 Initially, the IASB tentative decisions in response to the issues referred to the IFRS IC aimed at only addressing the subsequent measurement of the lease liability (that is 5b and 5c above).
- 10 However, in September 2020 the IASB considered an issue identified during the balloting process and decided to also address the initial measurement of the right-of-use asset and lease liability, to eliminate possible differences between the

method used by the seller-lessees to initially measure the ROU asset and the one used to measure the lease-liability arising from a leaseback.

- 11 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 (for instance by comparing the fair value of the right of use it retains to the fair value of the asset sold), the imputed lease payments could be different from the actual 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.
- 12 The IASB considered that requiring a seller-lessee to determine both the initial measurement of the ROU asset and its subsequent measurement based on the present value of the expected lease payments does not make it possible for a seller-lessee to impute lease payments with a different profile from those expected to achieve a desired accounting outcome.
- 13 The IASB considered alternative methods for subsequent measurement of the lease liability that would work with all possible methods of determining its initial measurement:
 - (a) **Input the expected payments:** that is determine the payments included in the measurement of the lease liability as those that, when discounted applying 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;
 - (b) **Input the discount rate** (that is consider the expected lease payments as the lease payments included in the initial measurement of the lease liability; and then impute the discount rate as that which would result in the carrying amount of the lease liability on initial recognition).
- 14 **The IASB rejected both alternatives** and concluded that they would make the requirements too complex and result in less understandable information, in particular:
 - (a) imputed expected payments: in this case the lease payments that a seller-lessee imputes could differ from the expected contractual lease payments; and
 - (b) imputed discount rate: the discount rate that would be imputed could be different from both the interest rate implicit in the lease and the seller-lessee's incremental borrowing rate.

Transition

- 15 In 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 when possible only without the use of hindsight); and
 - (b) To permit a seller-lessee to early apply the proposed amendment before the effective date; and

Illustrative example

- 16 The IASB also 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).#

Dissenting view of one IASB member

- 17 The Exposure Draft Lease Liability in a Sale and Leaseback, which proposes an amendment to IFRS 16 Leases, was approved for publication by 12 of 13 members of the International Accounting Standards Board. Ms Flores voted against its publication. Her alternative view is set out after the Basis for Conclusions.
- 18 This member disagreed in particular with the analysis and conclusions of the IASB in situations where variable payments are linked to future performance-.This member suggested to re-examine the matter; starting with the acknowledgment that IFRS 16 includes an implicit conflict between its sale and leaseback requirements and its definition of lease payments and related lease liability.
- 19 In its draft comment letter, EFRAG encourages the IASB to address this conflict, possibly as part of its forthcoming posit-implementation review of IFRS 16.

Questions for EFRAG TEG

- 20 Does EFRAG TEG have comments or questions on the background information contained in this cover note?
- 21 Does EFRAG TEG agree to recommend the draft comment letter contained in Agenda paper 06-02 for consideration by the EFRAG Board?

Agenda Papers

- 22 In addition to this cover note, agenda paper for this session are
 - (a) 06-02 – Draft Comment Letter - Lease Liability in a sale and leaseback; and
 - (b) 06-03 Exposure Draft - Lease Liability in a sale and leaseback (for background purposes only)