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Lease Liability in a Sale and Leaseback Cover note

Objective

- 1 The objective of session is to discuss and agree to recommend a Draft Endorsement Advice ('DEA') on the IASB's Amendments *Lease Liability in a Sale and Leaseback (Amendments to IFRS 16)*.
- 2 The EFRAG Secretariat also provides in agenda paper 01-04 an update on the IASB's most recent workplan-decisions regarding the post-implementation review of IFRS 16 *Leases*.

Background

- 2 IFRS 16 includes no specific subsequent measurement requirements for sale and leaseback transactions. Consequently, it is not always clear how to subsequently measure the leaseback liability, in particular when the leaseback payments include variable payments linked to future performance or use of the underlying asset, which otherwise are excluded from the measurement of a lease liability not related to a sale and leaseback transaction.
- 3 On 22 September 2022, the IASB published the *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 IASB Board member dissented with the issuance of the Amendments. This IASB Board member believed that a sale and leaseback transaction should be accounted for by the seller-lessee by recognising the full gain or loss on the transaction immediately. As this approach would have required the IASB to reconsider the sale and leaseback requirements in IFRS 16 as a whole, the IASB decided against.
- 4 Applying the amendments, a seller lessee shall:
 - (a) Apply the existing requirements in paragraph 100(a) of IFRS 16 for the initial recognition of the right-of-use asset and the gain or loss arising from the sale and leaseback and recognise a loss or gain only to the extent of the rights transferred in the transaction (no change).
 - (b) Apply paragraphs 29–35 to subsequently measure the right-of-use asset arising from the leaseback and paragraphs 36 to 46 to subsequently measure the lease liability arising from the leaseback (added paragraph 102A).

- (c) In applying paragraphs 36–46, the seller-lessee shall 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 (added paragraph 102A).
- 5 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.

Summary of previous discussions and EFRAG’s comment letter

- 6 In April 2021, EFRAG issued its final comment letter in response to the exposure-draft in which:
- (a) 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.
 - (b) 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.
 - (c) 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 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.
- 7 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.
- 8 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. 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.
- 9 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 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

- 10 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);

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- (c) reach out to industries where such transactions might have occurred (directly or through EFRAG's members organisations such as Europeanissuers and BusinessEurope) including the real-estate, hospitality and retail sector.
- 11 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).
- 12 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.
- 13 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.

EFRAG Financial Reporting Board discussion

- 14 At its 18 October 2022 meeting, the EFRAG Financial Reporting Board (EFRAG FRB) received an update on the project, including the EFRAG Secretariat research on prevalence.
- 15 Although the project had been initially identified as 'significant' by EFRAG FRB, FRB members agreed based on the evidence collected that the type of transactions addressed by the Amendments have not been prevalent in the EU, to apply a written procedure to approve the Draft Endorsement Advice.
- 16 Depending on the feedback received from the public consultation on the DEA, the EFRAG FRB could consider approval of the Final Endorsement advice at its 8 February 2023 meeting. The following timetable could therefore be considered:

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
EFRAG FRB approval of the FEA	8 February 2023

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(Alternatively, discussion of the topic in the FRB meeting in February 2023)	
Publication of the Final Endorsement Advice	10 February 2022

Draft endorsement advice

- 17 The EFRAG Secretariat has prepared a Draft Endorsement Advice and invitation to comment which are contained in agenda papers 0102 and 01-03, respectively.
- 18 Under the agreement with the IASB to use their copyrighted material, the Amendments are published to EFRAG's website ([here](#)) during the time necessary for EFRAG to complete its endorsement advice work. The Amendments will be removed from EFRAG's website when the EC will publish the regulation adopting the Amendments in the EU Official Journal.
- 19 The letter from the EC requesting endorsement advice is also published ([here](#)) on EFRAG's website.

Questions for EFRAG FR TEG members

- 20 Does EFRAG FR TEG have comments on the update on the IASB's decision and the research on prevalence of SLB with variable payments not based on index or rate?
- 21 Does the EFRAG FR TEG agree to recommend the Draft Endorsement Advice contained in agenda paper 01-02) and Invitation to Comment (contained in agenda paper 01-03) for approval by the EFRAG FRB?

Agenda Papers

- 22 In addition to this cover note, the following agenda papers are provided for this session:
 - (a) Agenda paper 01-02 – EFRAG's Draft Letter to the European Commission (DEA)
 - (b) Agenda paper 01-03 – Invitation to comment on EFRAG's assessments; and
 - (c) Agenda paper 01-04 - Update on the IASB's tentative decisions regarding the Post-implementation review of IFRS 16 (for background).