# Need to know

## IASB proposes to amend IFRS 16 *Leases* to clarify the measurement of lease liabilities in sale and leaseback transactions

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This *Need to know* addresses the proposed amendment to IFRS 16 *Leases* set out in Exposure Draft ED/2020/4 *Lease Liability in a Sale and Leaseback—Proposed amendment to IFRS 16* (the 'ED') published by the International Accounting Standards Board (Board) in November 2020.

- The changes proposed in the ED would amend IFRS 16 to:
  - specify the method a seller-lessee uses to measure initially the right-of-use asset and the liability arising in sale and leaseback transactions in which the transfer of the asset satisfies the requirements to be accounted for as a sale of the asset;
  - specify that the lease liability recognised for the leaseback reflects the expected lease payments and includes variable lease payments, including those that do not depend on an index or rate;
  - add subsequent measurement requirements for the lease liability arising in these sale and leaseback transactions; and
  - require a seller-lessee to apply the amendment retrospectively to sale and leaseback transactions entered into after the date of initial application of IFRS 16.
- The effective date for the proposed amendment will be decided after exposure. Earlier application is proposed to be permitted.
- Comments on the proposals are requested by 29 March 2021.

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## Background

The IFRS Interpretations Committee (Committee) received a request about a sale and leaseback transaction that includes variable payments, asking how the seller-lessee measures the right-of-use asset arising from the leaseback and, thus, determines any gain or loss to recognise at the date of the transaction.

In June 2020, the Committee published an **agenda decision** concluding that IFRS 16 provides an adequate basis for a seller-lessee to determine the accounting for the sale and leaseback transaction at the date of the transaction. However, the Committee's discussions on this matter highlighted the absence of specific subsequent measurement requirements for sale and leaseback transactions in IFRS 16, particularly for the lease liability. The Board decided to address this issue by proposing an amendment to IFRS 16.

## The proposed amendment

### Initial measurement of the right-of-use asset and the lease liability

The existing requirements of IFRS 16 specify that when the transfer of an asset in a sale and leaseback transaction satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale, the seller-lessee initially measures 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.

- The ED proposes to specify that this proportion is determined by comparing the present value of the expected lease payments (discounted using the interest rate implicit in the lease, if it can be readily determined, or otherwise the lessee's incremental borrowing rate), to the fair value of the asset sold.

  – Furthermore, the Board proposes to specify that the lease liability is initially measured at the present value of the expected lease payments that are not paid at the commencement date, discounted using the interest rate implicit in the lease, if it can be readily determined, or otherwise the lessee's incremental borrowing rate. The expected lease payments would comprise the following payments relating to the right to use the asset during the lease term at market rates:

a) fixed payments (including in-substance fixed payments), less any lease incentives;
b) variable lease payments (regardless of whether they depend on an index or a rate);
c) amounts expected to be payable by the seller-lessee under residual value guarantees; and
d) payments of penalties for terminating the lease, if the lease term reflects the seller-lessee exercising an option to terminate the lease.

### Subsequent measurement of the right-of-use asset and the lease liability

The seller-lessee would subsequently measure the right-of-use asset arising from the leaseback transaction applying the same subsequent measurement requirements as for right-of-use assets unrelated to sale and leaseback transactions.

The lease liability arising from the leaseback would subsequently be measured by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the expected lease payments for the reporting period as determined at the commencement date (or if applicable the revised expected lease payments for the reporting period as determined at the date of remeasurement). Therefore, the carrying amount would be reduced to reflect both the amount of those payments and when they were expected to be paid as at the commencement date.

The seller-lessee would generally recognise any difference between the actual payments made for the lease (excluding any above-market terms) and the expected lease payments for the reporting period in profit or loss. If there are shortfalls in the actual payments made (i.e. the payments made are less than the payments due) or recoveries of shortfalls, the seller-lessee would also adjust the carrying amount of the lease liability.

If a change in the lease term or a lease modification that is not accounted for as a separate lease occurs in a sale and leaseback transaction, the seller-lessee would remeasure the carrying amount of the lease liability, with the revised lease payments being the revised expected lease payments at the date of remeasurement. Except for a change in the lease term or a lease modification, the seller-lessee would not remeasure the lease liability to reflect a change in future variable lease payments.

**Observation**
In developing the proposed amendment, the Board considered two ways to subsequently measure the lease liability arising in a sale and leaseback transaction. The first was to measure it consistently with its initial measurement, including all expected payments regardless of whether they meet the definition of lease payments, whereas the second was to measure it in the same way as other lease liabilities, excluding payments that do not meet the definition of lease payments. The Board concluded that in order to reflect appropriately the economics of a sale and leaseback transaction and to prevent the recognition of a gain or loss on the right of use the seller-lessee retains via the leaseback, the subsequent measurement requirements for the lease liability should be consistent with its initial measurement.

The proposed amendment would apply to all sale and leaseback transactions but is expected to particularly affect sale and leaseback transactions that include variable lease payments not dependent on an index or rate.

The ED also proposes to add an example to the Illustrative Examples accompanying IFRS 16 to illustrate how a seller-lessee accounts for a sale and leaseback transaction that includes variable lease payments, in order to enhance the understandability of the proposed amendment.

**Observation**
In the ED, a Board member published an alternative view with regard to the circumstances in which payments to use an asset are variable payments linked to future performance. In contrast with the Board's analysis that forms the basis of the proposed amendment, the Board member's view is that a seller-lessee no longer has the same right to use the asset for the lease term as it had before the sale and leaseback transaction and such a significant change in their economic circumstances could justify the full derecognition of the asset sold and recognition of any related gain in full. Therefore, this Board member believes that this matter should be re-examined, starting with the initial request submitted to the Committee, and that it should be acknowledged that IFRS 16 currently includes an implicit conflict between its sale and leaseback requirements and its definition of lease payments and related lease liability. In order for this implicit conflict to be resolved, standard-setting that encompasses initial recognition would be required in the Board member's view.

## Transitional provisions, effective date and comment period
A seller-lessee would be required to apply the amendment retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to sale and leaseback transactions entered into after the date of initial application of IFRS 16.

However, if retrospective application to a sale and leaseback transaction that includes variable lease payments would be possible only with the use of hindsight, the seller-lessee would determine the expected lease payments for that transaction at the beginning of the annual reporting period in which the seller-lessee first applies the amendment. In these circumstances, the seller-lessee would:

a) measure the lease liability arising from the leaseback at the present value of the remaining expected lease payments at the date of initial application of the amendment, discounted using the rate specified in IFRS 16:37;

b) measure the right-of-use asset arising from the leaseback at its carrying amount as if the amendment had been applied since the commencement date, but measured using the remaining expected lease payments at the date of initial application of the amendment plus the actual payments made for the lease until that date; and

c) recognise the cumulative effect of applying the amendment as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application of the amendment.

The effective date of the amendment will be decided after exposure. Earlier application is proposed to be permitted. Comments on the proposals are requested by 29 March 2021.

## Further information
If you have any questions about the amendment to IFRS 16 please speak to your usual Deloitte contact.

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