IASB ISSUES AMENDMENTS TO IFRS 16 – LEASE LIABILITY IN A SALE AND LEASEBACK

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BACKGROUND

STATUS
Final

EFFECTIVE DATE
1 January 2024

ACCOUNTING IMPACT
The amendments may significantly affect subsequent measurement of lease liabilities arising from a sale and leaseback transaction with variable lease payments that do not depend on an index or rate.

On 22 September 2022, the IASB issued amendments to IFRS 16 – *Lease Liability in a Sale and Leaseback* (the Amendments).

In a sale and leaseback transaction the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor. The initial measurement of the lease liability that arises from a sale and leaseback transaction is a consequence of how the seller-lessee measures the right-of-use asset and the gain or loss recognised at the date of the transaction.

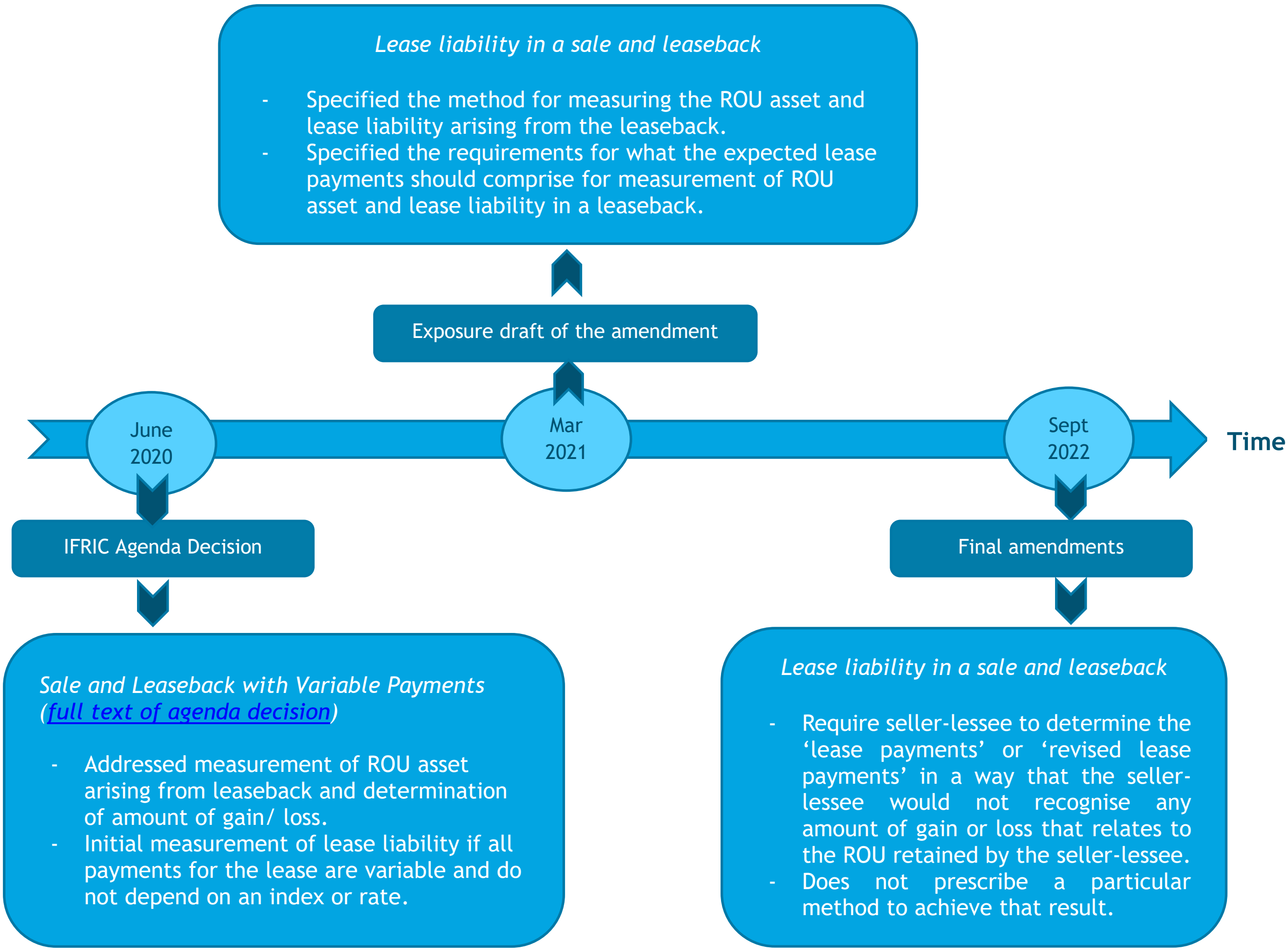
Prior to the Amendments, IFRS 16 did not contain specific measurement requirements for lease liabilities that may contain variable lease payments arising in a sale and leaseback transaction. In applying the subsequent measurement requirements of lease liabilities to a sale and leaseback transaction, the Amendments require a seller-lessee to 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.

Entities affected

The Amendments are expected to affect subsequent measurement of lease liabilities arising from a sale and leaseback transaction with variable lease payments that do not depend on an index or rate (e.g. payments that depend on a percentage of revenue derived from the asset’s use).

HISTORY OF THE ISSUE

The following diagram summarises the events that resulted in the Amendments, with the following sections explaining the events leading up to the Amendments:



What led to the IFRS Interpretations Committee agenda decision?

IFRS 16 Appendix A defines 'lease payments' that are to be included in the measurement of lease liabilities. The lease payments as defined in Appendix A exclude variable lease payments that do not depend on an index or rate (e.g. payments that depend on a percentage of revenue derived from the asset's use). Such variable payments are required to be recognised in profit or loss in the period in which the event or condition that triggers those payments occur.

In case of a sale and leaseback transaction, the seller-lessee transfers an asset to the buyer-lessor and leases that asset back from the buyer-lessor. In case of a transfer of an asset by the seller-lessee that satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale of the asset, IFRS 16.100(a) requires the seller-lessee to 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.

IFRS 16 does not prescribe a methodology for determining the proportion of the carrying amount of the asset that relates to the right of use retained by the seller-lessee. IFRS 16 also does not provide any requirements for subsequent measurement a lease liability arising from a sale and leaseback transaction.

Particularly in case of sale and leaseback transactions involving variable payments that do not depend on an index or rate, while measuring the lease liability, the seller-lessee would exclude variable payments that do not depend on an index or rate as these are excluded from the definition of lease payments in Appendix A. This measurement of lease liability may result in recognition of gain on the right-of-use retained by the seller-lessee, as sale and leaseback transactions would generally be economically structured considering the <u>expected</u> lease payments, which include the variable lease payments.

The following example illustrates the issue:

Illustration 1

Scenario A – variable lease payments that do not depend on an index or rate are excluded

An entity (seller-lessee) sells a building to another entity (buyer-lessor) for CU1,000,000, which is the fair value of the asset on the date of sale. Seller-lessee leases the building back from the buyer-lessor for a period of five years. The lease payments are comprised of annual fixed lease payment of CU50,000 and variable payment at 2% of revenue generated by the seller-lessee through use of the building.

The carrying value of the building on the date of the transaction is CU800,000. The interest rate implicit in the lease is not readily determinable. The incremental borrowing rate of the seller-lessee is 3%.

The present value of annual fixed lease payments of CU50,000 for five years discounted at the seller-lessee's incremental borrowing rate of 3% is CU228,985.

The seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right of use retained by seller-lessee, calculated as:

= Previous carrying amount * (present value of fixed lease payments / fair value of the building)
= 800,000 * (228,985 / 1,000,000)
= 800,000 * 22.89%
= 183,188

The gain on rights transferred is the total gain multiplied by the inverse of the percentage of rights retained:

= Total gain * (1 – rights retained)
= (1,000,000 – 800,000) * (1 – 22.89%)
= 200,000 * 77.11%
= 154,203

The seller-lessee would record the following entry on the date of the transaction:

DR Cash	CU1,000,000	
DR Right-of-use asset	CU183,188	
CR Building		CU800,000
CR Liability		CU228,985
CR Gain on transfer of asset		CU154,203

Scenario B - variable lease payments that do not depend on an index or rate are included

Assume that the present value of all lease payments including estimated variable payments that do not depend on an index or rate is CU400,000.

If this present value is used to measure the proportion of right-of-use retained, the right-of-use asset arising out of the leaseback would be CU320,000:

= Previous carrying amount * (present value of all lease payments / fair value of the building)
= 800,000 * (400,000 / 1,000,000)
= 800,000 * 40.00%
= 320,000

The gain on rights transferred would amount to CU120,000 calculated as:

= Total gain * (1 – rights retained)
= (1,000,000 – 800,000) * (1 – 40.00%)
= 200,000 * 60.00%
= 120,000

The seller-lessee would record the following entry on the date of the transaction:

DR Cash	CU1,000,000	
DR Right-of-use asset	CU320,000	
CR Building		CU800,000
CR Liability		CU400,000
CR Gain on transfer of asset		CU120,000

The total gain in the Scenario A is larger because the variable lease payments are not considered in the measurement of the lease liability.

This issue was highlighted in an agenda decision by the IFRS Interpretations Committee from June 2020.

IFRS Interpretations Committee Agenda Decision

In June 2020, the IFRS Interpretations Committee (the Committee) issued an agenda decision *(Sale and Leaseback with Variable Payments)* that addressed a request about sale and leaseback transactions with variable payments.

The request described a sale and leaseback transaction where payments for the lease include variable payments that do not depend on an index or rate. The variable payments were determined to be not in-substance fixed payments as described in IFRS 16.

The request asked how the seller-lessee measures the right-of-use asset arising from the leaseback, and thus determines the amount of any gain or loss recognised at the date of the transaction.

As noted by the Committee in the agenda decision, IFRS 16 does not prescribe a method for determining the proportion of the asset transferred (commonly property, plant equipment – PPE) to the buyer-lessor that relates to the right-of-use retained.

The Committee observed that in the transaction described in the request the seller-lessee could determine the proportion by comparing, for example, (a) the present value of expected payments for the lease **(including those that are variable)**, with (b) the fair value of the PPE at the date of the transaction. The amount of the gain or loss recognised relates only to the rights transferred to the buyer-lessor. The Committee further clarified that the seller-lessee also recognises a liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate.

The agenda decision also included an illustration describing the measurement of right-of-use asset, lease liability and calculation of gain or loss to be recognised on transfer for the fact pattern similar to the one described in the request.

In the agenda decision, the Committee concluded 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, at the Tentative Agenda Decision stage, the Committee recommended that the Board amend IFRS 16 to specify how the seller-lessee applies IFRS 16's subsequent measurement requirements to the lease liability that arises in the sale and leaseback transaction. This is because IFRS 16's subsequent measurement requirements would result in variable lease payments being recognised in profit or loss in the period in which the event or condition that triggers those payments occur, which would be inconsistent with the fact that the Agenda Decision would require all lease payments to be included in the initial measurement of the lease liability arising from a sale and leaseback transaction.

THE AMENDMENTS

In September 2022, the IASB amended IFRS 16. The Amendments add paragraph 102A to IFRS 16:

> After the commencement date, the seller-lessee shall apply paragraphs 29-35 to the right-of-use asset arising from the leaseback and paragraphs 36-46 to the lease liability arising from the leaseback. 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. Applying the requirements in this paragraph does not prevent the seller-lessee from recognising in profit or loss any gain or loss relating to the partial or full termination of a lease as required by paragraph 46(a).

The following are key points to note with regards to the Amendments:

1. <u>Exception to the general requirements of determination of 'lease payments':</u>

   Lease payments as defined in Appendix A to IFRS 16 comprise the following:

   a) *fixed payments (including in-substance fixed payments), less any lease incentive*
   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.*

   Variable lease payments that do not depend on an index or rate are not included in the definition of lease payments and these payments are not included in the measurement of lease liabilities.

   If the same definition is applied to a leaseback, the seller-lessee, in a leaseback transaction involving variable payments that do not depend on an index or rate, would measure the lease liability <u>without</u> considering these variable payments. That may result in recognition of a gain on the right-of-use retained by the seller-lessee, as demonstrated in Illustration 1 – Scenario A above.

To prevent this accounting outcome, the Amendments create an exception to the definition of ‘lease payments’ applicable for other than sale and leaseback transactions, by requiring the seller-lessee to 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.

2. Specific measurement requirements not prescribed

   The Amendments do not prescribe specific measurement requirements for lease liabilities arising from a sale and leaseback.

   Refer to the illustrations below, which illustrate approaches that may be followed by the seller-lessee. The seller-lessee may apply other methodologies to determined lease payments subject to the requirements of the Amendments i.e. 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.

Illustration

The following example illustrates application of the requirements of the Amendments to a sale and leaseback transaction with variable payments that do not depend on an index or rate:

Illustration 2

On 1 January 20X1, Entity A (seller-lessee) sells a piece of machinery to Entity B (buyer-lessor) for consideration of CU2,500,000, which is the fair value of the machinery at the date of sale.
The carrying value of the machinery immediately before the sale is CU2,000,000.

At the same time as the sale transaction, the seller-lessee enters into a lease contract with the buyer-lessor for use of the machinery, for a period of five years. Lease payments consist of fixed payments of CU50,000 per annum and variable payments at 3% of the revenue generated from the use of the machinery. The variable payments are determined to be not in-substance fixed payments.

The transfer of the machinery meets the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale.

Accordingly, seller-lessee accounts for the transaction as a sale and leaseback.

The interest rate implicit in the lease cannot be readily determined. Seller-lessee’s incremental borrowing rate is 4%.

The seller-lessee expects to consume the right-of-use asset’s future economic benefits evenly over the lease term.

Scenario 1:

At the commencement of the leaseback, the seller-lessee is able to estimate the revenue for the period of the lease. The estimated revenue at lease commencement is as below:

Year	Revenue (CU)
20X1	1,500,000
20X2	1,600,000
20X3	1,650,000
20X4	1,700,000
20X5	1,800,000

Assessment:

A. Determination of proportion of right-of-use retained

IFRS 16.100(a) requires the seller-lessee to 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.

IFRS 16, as amended, does not prescribe a method for determining this proportion.

One possible method is to compare the present value of expected lease payments (including those that are variable) with the fair value of the asset at the date of the transaction.

Following this method, seller-lessee measures the present value of expected lease payments as below:

(Amounts in CU)

Year	Fixed lease payment	Estimated revenue	Variable lease payments (3% of estimated revenue)	Total lease payment	Present value (discounted at incremental borrowing rate of 4%)
20X1	50,000	1,500,000	45,000	95,000	91,346
20X2	50,000	1,600,000	48,000	98,000	90,607
20X3	50,000	1,650,000	49,500	99,500	88,455
20X4	50,000	1,700,000	51,000	101,000	86,335
20X5	50,000	1,800,000	54,000	104,000	85,480
				Total	**442,223**

The seller-lessee arrives at the proportion of the carrying amount of the machinery related to the right-of-use retained to be 17.7%, calculated as [CU442,223 (present value of expected lease payments)/ CU2,500,000 (fair value of the machinery)].

It should be noted that IFRS 16 does not prescribe a method for determining the proportion of the carrying amount of the asset that relates to the right-of-use retained.

The approach described above is one of the possible methods. Entities may use other methods depending on the facts and circumstances.

B. Measurement of right-of-use asset and lease liability at commencement

The lease liability at commencement of the leaseback transaction is measured at CU442,223, which is the present value of expected lease payments.

The right-of-use asset at commencement is measured at CU353,778, calculated as CU2,000,000 (previous carrying amount of the machinery) * 17.7% (proportion of the machinery that relates to the right-of-use retained).

C. Determination of gain on rights transferred

The proportion of rights transferred is 82.3% (1 – 17.7%). The gain on rights transferred is measured at CU411,555, calculated as CU500,000 (total gain on sale of the machinery (CU2,500,000 – CU2,000,000) * 82.3%.

D. Accounting entry on the date of the transaction

At the date of the transaction, the seller-lessee accounts for the transaction as below:

DR Cash	CU2,500,000	
DR Right-of-use asset	CU353,778	
CR Machinery		CU2,000,000
CR Lease liability		CU442,223
CR Gain on rights transferred		CU411,555

E. Subsequent measurement of the right-of-use asset

The seller-lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

F. Subsequent measurement of the lease liability

Approach - Expected lease payments at the commencement date

Applying IFRS 16.102A, the seller-lessee determines 'lease payments' to reflect the expected lease payments at the commencement date that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at that date of CU442,223.

Under this approach, the lease liability arising from the leaseback is:

(Amounts in CU)

Year	Opening lease liability	Interest @ incremental borrowing rate of 4%	Lease payments	Closing lease liability
20X1	442,223	17,689	95,000	364,912
20X2	364,912	14,596	98,000	281,509
20X3	281,509	11,260	99,500	193,269
20X4	193,269	7,731	101,000	100,000
20X5	100,000	4,000	104,000	-

In accordance with the requirements of IFRS 16.102A and IFRS 16.38(b), any difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability is recognised in profit or loss. For example, if the seller-lessee pays CU103,000 in year 20X2 for the use of the machinery, it recognises CU5,000 (CU103,000 – CU98,000) in profit or loss.

Scenario 2:

At the commencement of the leaseback, the seller-lessee is not able to estimate the revenue for the period of the lease.

The estimated remaining useful life of the machinery is 20 years.

Assessment:

A. Determination of proportion of right-of-use retained

IFRS 16.100(a) requires the seller-lessee to 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.

IFRS 16, as amended, does not prescribe a method for determining this proportion.

Since the seller-lessee is not able to estimate the revenue for the period of the lease, the method followed in Scenario 1 of estimating expected lease payments cannot be followed.

Considering the facts and circumstances, a possible approach is to compare the lease period (5 years to the remaining useful life of the asset (20 years). Based on this, the proportion of the previous carrying amount of the asset that related to the right-of-use retained by the seller-lessee is 25%.

It should be noted that IFRS 16 does not prescribe a method for determining the proportion of the carrying amount of the asset that relates to the right-of-use retained.

The approach described above is one of the possible methods. Entities may use other methods depending on the facts and circumstances.

B. Measurement of right-of-use asset and lease liability at commencement

The right-of-use asset at commencement is measured at CU500,000, calculated as CU2,000,000 (previous carrying amount of the machinery) * 25% (proportion of the machinery that relates to the right-of-use retained).

The lease liability at commencement of the leaseback transaction is measured at CU625,000, calculated as CU2,500,000 (fair value of the machinery on the date of the transaction) * 25% (proportion of the machinery that relates to the right-of-use retained).

C. Determination of gain on rights transferred

The proportion of rights transferred is 75% (1 – 25%). The gain on rights transferred is measured at CU375,000, calculated as CU500,000 (total gain on sale of the machinery (CU2,500,000 – CU2,000,000) * 75%.

D. Accounting entry on the date of the transaction

At the date of the transaction, the seller-lessee accounts for the transaction as below:

DR Cash CU	2,500,000	
DR Right-of-use asset	CU500,000	
CR Machinery		CU2,000,000
CR Lease liability		CU625,000
CR Gain on rights transferred		CU375,000

E. Subsequent measurement of the right-of-use asset

The seller-lessee expects to consume the right-of-use asset’s future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

F. Subsequent measurement of the lease liability

Approach – Equal lease payments over the lease term

As the seller-lessee is unable to estimate revenue for the period of the lease and the lease liability at initial recognition is not measured as the present value of expected lease payments, the seller-lessee will be unable to follow the approach or subsequent measurement of lease liability used in scenario 1.

An alternate approach that the seller-lessee can use is imputing equal lease payments over the lease term.

Under this approach, applying IFRS 16.102A, the seller-lessee determines 'lease payments' to reflect equal periodic payments over the lease term that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at the commencement date of CU625,000.

Under this approach, the lease liability arising from the leaseback is:

(Amounts in CU)

Year	Opening lease liability	Interest @ incremental borrowing rate of 4%	Lease payments	Closing lease liability
20X1	625,000	25,000	140,392	509,608
20X2	509,608	20,384	140,392	389,600
20X3	389,600	15,584	140,392	264,792
20X4	264,792	10,592	140,392	134,992
20X5	134,992	5,400	140,392	-

In accordance with the requirements of IFRS 16.102A and IFRS 16.38(b), any difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability is recognised in profit or loss. For example, if the seller-lessee pays CU150,000 in year 20X2 for the use of the machinery, it recognises CU9,608 (CU150,000 – CU140,392) in profit or loss.

As can be seen from the above illustration, the measurement of right-of-use asset and lease liability recognised in a sale and leaseback transaction will differ based on facts and circumstances of each case, even though the contractual terms of the lease agreement are the same.

As noted by the IASB in Basis for Conclusions to the Amendments (IFRS 16.BC294A(c)), the Amendments do not require the seller-lessee to estimate the expected lease payments.

Therefore, in case of a leaseback that includes variable lease payments that do not depend on an index or rate, the seller-lessee will need to develop its accounting policy for determining lease payments as required by IFRS 16.102A. In other words, the lease payments should be determined in such 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. Specific methodology for this determination is not prescribed by the Amendments. Seller-lessee would formulate the methodology depending on the facts and circumstances of the case.

Effective date and transition

The Amendments are effective for annual reporting periods beginning on or after 1 January 2024, with earlier application permitted. If a seller-lessee applies these amendments for an earlier period, it shall disclose that fact.

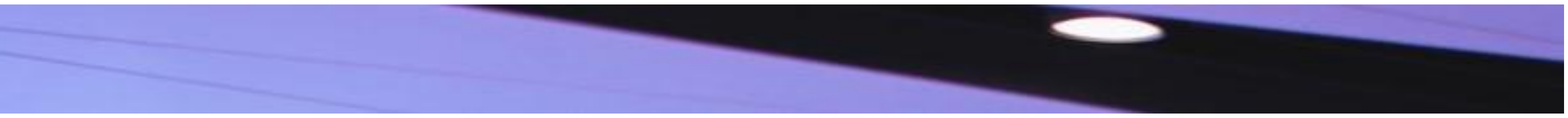
A seller-lessee shall apply the Amendments retrospectively in accordance with IAS 8 to sale and leaseback transactions entered into after the date of **initial application of IFRS 16**. Thus, if the date of initial application of IFRS 16 for a seller-lessee was 1 January 2019, the Amendments would apply to the sale and leaseback transactions entered into after 1 January 2019. This is because specific transitional requirements applied to sale and leaseback transactions that occurred prior to the date of initial application of IFRS 16, and those transactions are unaffected by the Amendments.

Which entities will be significantly affected?

As noted by the IASB in the Basis for Conclusions (IFRS 16.BC294A(b)), the amendments are expected to affect only the subsequent measurement of lease liabilities arising from a sale and leaseback transaction:

(i) with variable lease payments;
(ii) occurring from the date of initial application of IFRS 16 (1 January 2019 for most seller-lessees); and
(iii) for which the seller-lessee's accounting policy differs from the requirements specified in these amendments.

However, sale and leaseback transactions often involve high value items of property, plant and equipment with long economic lives. If the measurement methodology followed by the seller-lessee was not in compliance with the requirements of the Amendments, the Amendments may have significant effect on the financial statements on transition. This would be likely in cases where the leaseback involved variable payments that do not depend on an index or rate and these are not considered in the lease liability arising from the leaseback i.e. the lease liability considers only fixed lease payments, if any. Such treatment may have resulted in recognition of gain that relates to the right-of-use retained by the seller-lessee.



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