Sale and leaseback

For lessees and lessors

IFRS 16

February 2023

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Assessing sale and leaseback

IFRS 16 *Leases* ended sale-and-leaseback transactions as an off-balance sheet financing proposition. However, it did not end the debates about sale-and-leaseback accounting.

Accounting for sale-and-leaseback transactions can be complex. The deals themselves are often highly structured and can be material, especially for seller-lessees. Assessing whether a transaction qualifies for sale-and-leaseback accounting under IFRS 16 is a key judgement. Calculating the profit or loss on the sale is also not always intuitive.

Therefore, it is no surprise that questions on how to account for sale-and-leaseback transactions with variable payments led to the first substantive amendments to IFRS 16. Those amendments are not yet effective but will require seller-lessees to reassess sale-and-leaseback transactions entered into since applying IFRS 16.

This new guide to sale-and-leaseback accounting addresses practical questions we have encountered in applying IFRS 16. It also covers the new amendments, with detailed worked examples showing how to account for sale-and-leaseback transactions that feature variable payments on initial recognition and subsequently.

Whether you are assessing how to account for a new sale-and-leaseback transaction or seeking to understand the impact of the recent amendments to IFRS 16 on existing sale-and-leaseback transactions, we hope you will find this guide helpful.

More in-depth guidance on complex areas of IFRS 16 – including lease modifications, lease term, discount rates and real estate leases – is available at kpmg.com/ifrs16.

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1 At a glance

In a sale-and-leaseback transaction, a seller-lessee transfers an asset to a buyer-lessor and leases that asset back for a period of time.

To determine how to account for a sale-and-leaseback transaction, a company first considers whether the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale (see Section 2).

The company applies IFRS 15 *Revenue from Contracts with Customers* to determine whether a sale has taken place – i.e. whether control of the underlying asset passes to the buyer-lessor. If, for example, the contract includes a substantive option that permits the seller-lessee to repurchase the underlying asset, then the transfer would not be a sale under IFRS 15 and, therefore, sale-and-leaseback accounting would be precluded under IFRS 16.

This assessment determines the accounting by both the seller-lessee and the buyer-lessor, as follows.

	Seller-lessee	Buyer-lessor
Transfer[1] to buyer-lessor is a sale – see Sections 3 and 4	• Derecognise the underlying asset and apply the lessee accounting model to the leaseback. • Measure the right-of-use asset as a portion of the previous carrying amount of the underlying asset. • Recognise only the amount of any gain or loss related to the rights transferred to the buyer-lessor.	• Recognise the underlying asset and apply the lessor accounting model to the leaseback.
Transfer to buyer-lessor is not a sale – see Section 5	• Continue to recognise the underlying asset. • Recognise a financial liability under IFRS 9 *Financial Instruments* for any amount received from the buyer-lessor.	• Do not recognise the underlying asset. • Recognise a financial asset under IFRS 9 for the amount transferred to the seller-lessee.

Note:

1 Adjustments are made if the sale is not at fair value or the lease payments are off-market.

If the transfer is a sale, then the seller-lessee always measures the right-of-use asset as a proportion of the carrying amount of the underlying asset. This means that even if all of the lease payments are variable, the seller-lessee always recognises a right-of-use asset and, unless the lease payments are prepaid, a liability (see Section 3).

The recent amendments[1] to IFRS 16 require that the seller-lessee applies the subsequent measurement requirements in such a way that it does not recognise a gain or loss associated with the rights retained under the leaseback. These new amendments are effective from 1 January 2024 (see Section 6).

[1] *Lease Liability in a Sale and Leaseback (Amendments to IFRS 16)* issued September 2022.

2 Identifying a sale-and-leaseback transaction

The key to identifying a sale-and-leaseback transaction is to determine whether a sale occurs. This is critical because if there is no sale then the transaction is accounted for as a financing arrangement.

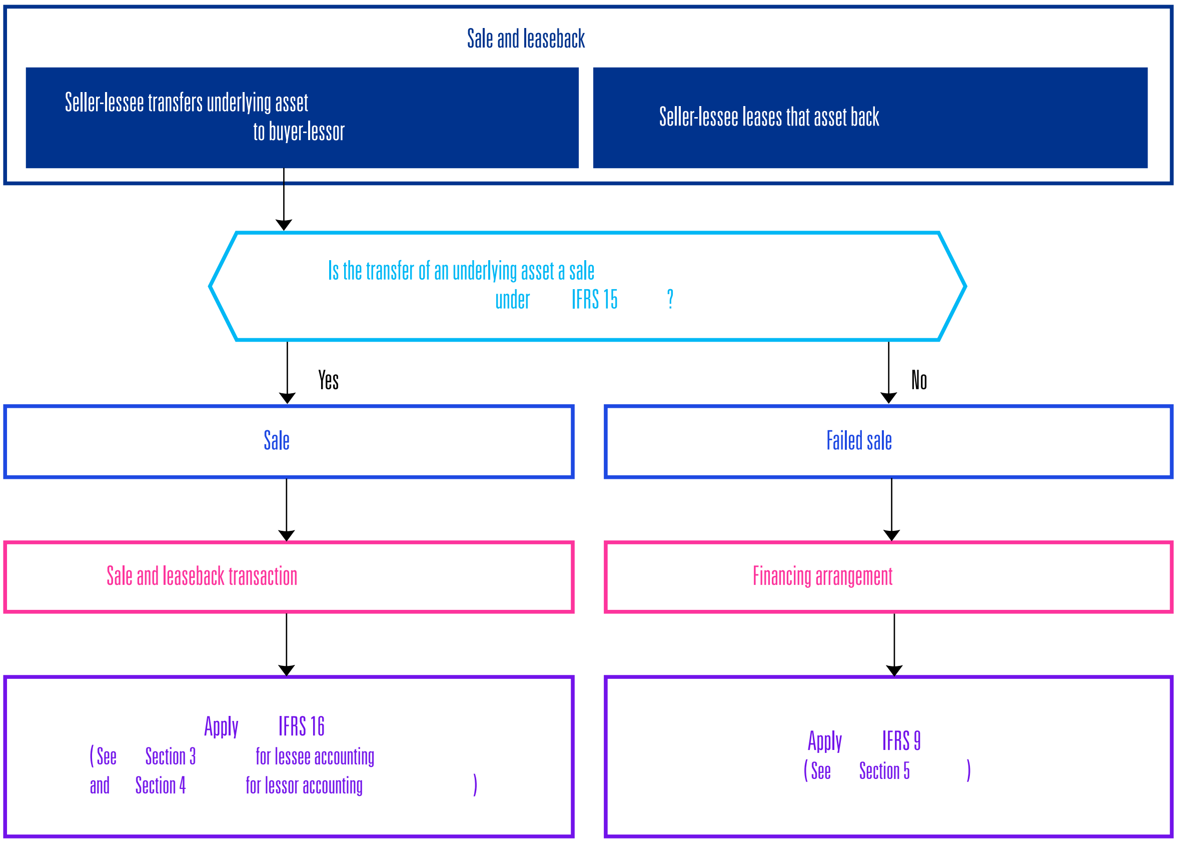
2.1 Is there a sale?

IFRS 16.98 In a sale-and-leaseback transaction, a company (the seller-lessee) transfers an underlying asset to another company (the buyer-lessor) and leases that asset back from the buyer-lessor.

IFRS 16.99 To determine how to account for a sale-and-leaseback transaction, a company first considers whether the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale under IFRS 15.

IFRS 16.100 If the transfer of the asset meets the requirements for a sale in IFRS 15, then a sale has occurred and the transaction is accounted for as a sale-and-leaseback transaction under IFRS 16.

IFRS 16.103 If the transfer of the asset does not meet the requirements for a sale in IFRS 15, then there is no sale and the transaction is accounted for as a financing arrangement under IFRS 9.


Sale and leaseback
Seller-lessee transfers underlying asset to buyer-lessor
Seller-lessee leases that asset back
Is the transfer of an underlying asset a sale under IFRS 15?
Yes
No
Sale
Failed sale
Sale and leaseback transaction
Financing arrangement
Apply IFRS 16 (See Section 3 for lessee accounting and Section 4 for lessor accounting)
Apply IFRS 9 (See Section 5)

Example 1 – The transfer is a sale

Company B transfers an office building to Company C for 1,000,000 and at the same time leases the building back with fixed lease payments at market rate for 10 years. The contract includes a put option that gives C a right to require B to repurchase the building for 900,000 two years into the lease. If C exercises the put option, the lease is terminated. C does not have a significant economic incentive to exercise the option (see Section 5.5 of our Revenue – IFRS 15 handbook).

B and C apply IFRS 15 to determine whether a sale has taken place. Under IFRS 15, a written put option does not in itself prevent a company from transferring control of an asset to the customer. B and C note that the exercise price of the put option is lower than the original selling price of the asset and C does not have a significant economic incentive to exercise the option. This means that if the transfer were a stand-alone revenue transaction, B would account for it as a sale with a right of return.

Therefore, B and C conclude that the transfer of the building to C qualifies as a sale under IFRS 15 and apply the sale-and-leaseback guidance in IFRS 16.

See Section 3 for B's accounting as seller-lessee and Section 4 for C's accounting as buyer-lessor.

Example 2 – The transfer is not a sale

Company B transfers an office building to Company C for 1,000,000 and at the same time leases the building back with fixed lease payments at market rate for 10 years. The contract includes a repurchase option that B can exercise for 1,200,000 from five years into the lease. If B exercises the repurchase option, the lease is terminated.

B and C apply IFRS 15 to determine whether a sale has taken place. Under IFRS 15, if a substantive repurchase option is in the form of a forward or a call option, then a company has not transferred control of the asset to the customer.

Therefore, B's transfer of the building to C does not qualify as a sale under IFRS 15 and is accounted for as a finance arrangement under IFRS 9.

See Section 5 for the accounting for a failed sale.

Do the seller-lessee and buyer-lessor apply the same test when considering if a transfer is a sale?

Yes. Both parties consider whether the transfer of the asset by the seller-lessee satisfies the requirements in IFRS 15 to be accounted for as a sale of the asset. If it does not, then the consideration for the transfer is accounted for in accordance with IFRS 9.

In practice, it is possible that a seller-lessee and a buyer-lessor might reach different conclusions about a particular transaction – e.g. due to information asymmetry or different assessments of the judgemental aspects of IFRS 15's requirements. However, the requirements themselves are identical for the seller-lessee and the buyer-lessor.

What might commonly preclude a transfer from being a sale?

Some of the features that commonly preclude a transfer from being a sale include the following.

- ***Seller-lessee's repurchase option:*** Under IFRS 15, a substantive repurchase option in the form of a call option or a forward precludes a sale.
- ***Seller-lessee's renewal option:*** In some cases, a renewal option may be similar in economic substance to a purchase option. For example, if a leaseback contains a fixed-price renewal option that the seller-lessee is reasonably certain to exercise and which would extend the lease term to cover substantially all of the remaining economic life of an underlying asset, then this may preclude a sale.
- ***Buyer-lessor's put option:*** Under IFRS 15, a substantive repurchase option in the form of a written put option does not by itself preclude a sale. Instead, the contracting parties need to evaluate the specific terms and conditions of the put option. If the exercise price of the put option is higher than the original selling price of an asset and also greater than the expected market value of that asset, then this would generally preclude a sale.
- ***Finance leaseback:*** The buyer-lessor classifying a leaseback as a finance lease does not in itself preclude a sale. However, in our experience, only in rare circumstances would the transfer qualify as a sale when the leaseback is a finance lease. See below for more detail.

Can you have a sale and finance leaseback?

IFRS 16.BC262(a)

Technically, yes, but it is expected to be rare.

The International Accounting Standards Board (IASB) observed that the presence of a leaseback does not, in isolation, preclude the seller-lessee from concluding that it has transferred the underlying asset to the buyer-lessor. This is because a lease differs from a sale – i.e. a lease does not transfer control of the underlying asset to the lessee; instead, it transfers the right to control the use of the underlying asset for the period of the lease.

If the leaseback is classified as a finance lease, then it is more likely to contain features that cause the seller-lessee to effectively retain control of the underlying asset rather than obtaining a right to control the use of that asset. In this case, the transfer would fail the IFRS 15 test.

Does a failed sale need to be reassessed?

It depends. Generally, the passage of time alone would not result in a reassessment. However, if a change in facts and circumstances indicates that the rights and obligations of the contracting parties have changed, then it may need to be reassessed. For example, if a substantive repurchase option that previously contributed to a failed-sale conclusion lapses without being exercised, then a company would reassess whether the transfer now qualifies as a sale. This could result in sale-and-leaseback accounting from the date of the lapse, depending on the other facts and circumstances.

Does the legal form of the transfer matter?

IFRS 16.BC261

No. The IASB noted that when a company is considering whether a transaction is accounted for as a sale-and-leaseback transaction, it needs to consider not only those transactions structured in the form of a legal sale-and-leaseback, but also other forms of transactions for which the economic effect is the same as a legal sale-and-leaseback – e.g. some lease-and-leaseback transactions.

2.2 Unit of account

IFRS 16.99

IFRS 16 describes a sale-and-leaseback as a transaction in which a company transfers an asset to another company and leases back that asset. Questions can arise regarding whether to apply sale-and-leaseback accounting in specific circumstances – e.g. when:

- a company transfers an asset and leases back a portion of that asset;
- a company transfers a portfolio of assets and leases back only some assets in the portfolio; and
- the assets subject to the transaction are fungible – i.e. they are essentially interchangeable, as is generally the case for commodities.

If a sale-and-leaseback transaction involves land and buildings previously accounted for by the seller-lessee under IAS 16 *Property, Plant and Equipment*, then it appears that the land and buildings need to be assessed separately when applying IFRS 15 to determine whether a sale has taken place. This is because under IAS 16 land and buildings are recognised as separate assets and its requirements on asset disposals apply separately to each item of property, plant and equipment.

Example 3 – Sale and leaseback of land and buildings

Company B transfers an item of real estate to Company C and at the same time leases it back for 20 years, which is equal to the economic life of the building. The real estate comprises the building and the freehold land on which it stands.

When applying IFRS 15 to determine whether a sale has taken place, B assesses the land and building separately, considering the following.

- The land and the building were accounted for separately under IAS 16.
- The derecognition requirements in IAS 16 apply separately to each item of property, plant and equipment.

This may result in different conclusions for the land and the building – i.e. the transfer of the land, which typically has an indefinite useful life, may qualify as a sale but the transfer of the building may not.

Are land and buildings always treated separately when identifying a sale-and-leaseback transaction?

No. It depends on the facts and circumstances. A key consideration is how the seller-lessee accounted for the land and buildings before the transaction.

In Example 3 above, Company B classifies the land and the building as property, plant and equipment. Specifically, B recognises them as separate items. B depreciates the building over its useful life but does not depreciate the land.

However, the unit of account for this assessment would differ if B classified the item of real estate as investment property with no own-use element and applied the fair value model. In this case, B would treat the real estate as a single unit of account under IAS 40 *Investment Property*. If B transferred the real estate to another party and leased it back, then B would treat the real estate as a single unit of account when assessing whether sale-and-leaseback accounting applies.

If a company sells a building and leases part of it back, what is the unit of account for determining whether the transaction qualifies for sale-and-leaseback accounting?

Consider an example where Company B transfers a 10-storey building to Company C and immediately leases five floors back.

There is no guidance in IFRS 16 on what the unit of account is in such cases. In our view, one acceptable approach may be to consider the requirements in paragraph 10 of IAS 40 by analogy. IAS 40 requires a portion of a property held-for-use and a portion held for rentals and/or capital gains to be considered separately if that portion could be sold separately or leased out separately under a finance lease.

Applying this guidance by analogy, if each floor could be sold or leased out separately under a finance lease, B would determine whether a sale has occurred for each floor. This would lead to B accounting for a sale of the five floors that have not been leased back, provided that there is no other factor preventing a sale. B would account for the other five floors that have been leased back as being subject to either a sale-and-leaseback transaction or a financing.

If each floor could not be sold or leased separately under a finance lease, B would determine whether a sale has occurred for the whole building. Therefore, either the transfer of the whole building qualifies as a sale, and sale-and-leaseback accounting applies, or the transfer of the whole building is a failed sale, and accounted for as a financing transaction.

We believe another acceptable approach would be to consider *only* whether the floors could be sold separately. If this were the case, B would determine whether a sale has occurred for each floor. If not, it would determine whether a sale has occurred for the whole building.

Can you have a sale and leaseback of a commodity?

This is a complex area and different considerations may apply in different cases. One of the common characteristics of commodities is that they are largely fungible – e.g. a gold bar can easily be replaced with another similar gold bar. Because of this characteristic, in commodity loan transactions a contract is unlikely to require that the asset returned at the end of the contract term is the specific asset loaned.

In a stand-alone transaction described as a 'lease' of a commodity, the lease definition is often not met because there is no identified asset – i.e. the commodity is fungible. By extension, a contract described as a sale and leaseback of a commodity will not be a sale and leaseback if the leaseback does not meet the definition of a lease.

Complications might arise if the contract includes the transfer of a commodity and a call option without a leaseback. Under IFRS 15, a substantive call option precludes a sale when that option relates to the original asset transferred or 'an asset that is substantially the same as that asset'. In this situation, when there is no sale, IFRS 15 requires that the transaction is accounted for as a lease when the exercise price of the call option is lower than the original selling price. However, the lease definition in IFRS 16 would not be met because there is no identified asset. The IASB decided to leave this as an unresolved issue, expecting such transactions to be unlikely.

Can you have a sale and leaseback of a digital asset?

It depends. This is another complex area with different considerations applying in different cases. A key consideration will often be whether the digital asset can be an identified asset – e.g. can it be uniquely identified or is it fungible? If the digital asset is fungible, then the considerations for commodities discussed above will apply.

2.3 Lessee controls an asset

IFRS 16.B46 Sale-and-leaseback accounting may be required if a lessee controls the underlying asset before it is transferred to the lessor.

IFRS 16.B47 If the lessee does not control the underlying asset before it is transferred to the lessor, then the transaction is a lease and not a sale-and-leaseback transaction.

IFRS 16.B45 A lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine whether the lessee controls the asset before it is transferred to the lessor.

Example 4 – Lessee controls an asset under construction

Company B and Company C enter into a contract under which C will construct a building on B's land and will lease that building to B. Specific terms and conditions of the contract are as follows.

- B will lease its land to C for a fixed term of 50 years.
- C will construct the building on the leased land, starting after the land lease has commenced. Construction will take approximately two years. The economic life of the building is expected to be 40 years.
- C will fund the construction costs of the building.
- The building will be constructed to B's specifications. However, it will follow a general design for office buildings in an area where there is a high demand for similar buildings.
- On completing construction, C will lease the building to B for a fixed term of five years. The lease of the building does not include a renewal option.
- B does not have a right to purchase the building during construction.

B needs to determine whether it controls the building during construction. If it does, then it will account for the transaction as a sale-and-leaseback transaction – i.e. starting from the beginning of construction, B will recognise the building as a construction-in-progress asset with a corresponding liability for the construction costs funded by C. Conversely, if B does not control the building during construction, then it will recognise a lease of the building only when the construction is complete and the lease commences.

IFRS 16 does not define control. Therefore, when assessing control, B considers the definition in IFRS 15 – i.e. the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Applying this definition, B considers the following.

- B does not have a right to purchase the building during construction.
- The completed building will not be highly customised and as such will have alternative use to C.
- C leases the land for 50 years, which covers substantially all of the economic life of the building. This means that C controls the right to use the land for at least substantially all of the economic life of the building.

Following its assessment, B concludes that it does not control the building during construction. Therefore, the transaction is a lease and not a sale-and-leaseback, and will be accounted for in B's financial statements only after construction is complete and the lease commences.

What factors does a company need to consider when assessing whether it controls an asset before transfer to the lessor?

Control is not defined in IFRS 16. Under paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, management uses judgement to develop and apply an accounting policy when there is no IFRS® Accounting Standard that specifically applies to a transaction, other event or condition. The hierarchy in paragraph 11 of IAS 8 requires that a company consults other IFRS Accounting Standards – e.g. IFRS 15. This standard was developed in a similar timeframe to IFRS 16 and is generally viewed as having a definition of control that is consistent with IFRS 16.

Under paragraph 33 of IFRS 15, control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Paragraph 35 further explains situations where control is transferred over time, which may be especially relevant in assessing control over an asset under construction.

How does a lessee assess whether sale-and-leaseback accounting is required when multiple parties are involved?

IFRS 16.B45-B47

For highly-customised assets, a manufacturer, a lessor and a lessee may enter into a negotiation for the purchase of an asset from the manufacturer by the lessor, which in turn is leased to the lessee.

For example, an aircraft manufacturer, a bank (lessor) and an airline company (lessee) may negotiate that the aircraft manufacturer will build an aircraft to the airline company's specifications, but it will be the bank that purchases the aircraft and then leases it to the airline company.

In determining whether sale-and-leaseback accounting is required, the key question is whether the airline company obtains control of the aircraft before it is purchased by the bank.

If it is determined that the bank obtains control of the aircraft from the aircraft manufacturer before it is leased to the airline company, then the transaction will be accounted for solely as a lease between the bank (lessor) and the airline company (the lessee): there is no sale and leaseback.

In contrast, if the airline company is determined to obtain control of the aircraft from the aircraft manufacturer, then the arrangement between the airline company and the bank will be accounted for as a sale and leaseback.

In some cases, legal title of the asset may momentarily be transferred to the lessee (i.e. the airline company in our example) before it eventually transfers to the lessor (i.e. the bank). This may occur for various reasons, including tax and legal. However, paragraph B47 of IFRS 16 indicates that this alone does not mean that the lessee controlled the asset before its acquisition by the lessor.

2.4 Old sale-and-leaseback transactions

IFRS 16.C16

The discussion in the preceding sections does not apply to sale-and-leaseback transactions entered into before the date of initial application of IFRS 16. This is because on transition to IFRS 16 a company did not reassess sale-and-leaseback transactions entered into before the date of initial application to determine whether a sale occurred under IFRS 15.

IFRS 16.C17

Instead, for a sale-and-leaseback transaction accounted for as a sale and a finance lease under IAS 17 Leases, the seller-lessee:

- accounted for the leaseback in the same way as for any finance lease that existed at the date of initial application; and
- continued to amortise any gain on the sale over the lease term.

IFRS 16.C18

Similarly, for a sale-and-leaseback transaction accounted for as a sale and an operating lease under IAS 17, the seller-lessee:

- accounted for the leaseback in the same way as for any other operating lease that existed at the date of initial application; and
- adjusted the leaseback right-of-use asset for any deferred gains or losses that related to off-market terms recognised in the statement of financial position immediately before the date of initial application.

Example 5 – Old sale-and-leaseback transaction that would be a failed sale under IFRS 16

IFRS 16.99, 103, C18, IFRS 15.B66

In 2004, Company R sold its head office building to Company P and leased the building back for 20 years. R has an option to repurchase the building for its market value between years 16 and 20.

In assessing the classification of the leaseback under IAS 17, R noted that the exercise price of the repurchase option was at market value and therefore P retained the risk (reward) of any change in the market value of the building. R also noted that there were no other indicators that the leaseback was a finance lease. R therefore accounted for this transaction as a sale and operating leaseback – i.e. R derecognised the building and recognised the rentals payable to P as an expense on a straight-line basis over the term of the leaseback.

On 1 January 2019:

- R's leaseback of its head office building has a remaining term of five years; and
- the present value of the lease payments, discounted at R's incremental borrowing rate at 1 January 2019, is 500.

R notes that its option to purchase the building means that the transaction does not meet the criteria to be recognised as a sale under IFRS 15. This means that if R entered into the transaction on these terms after adopting the new standard, then it would account for it as a financing under IFRS 9 and not as a sale-and-leaseback. However, because the transaction was in place at the date of initial application of IFRS 16, R continues to account for it as a sale-and-leaseback.

R elects to adopt IFRS 16 using a modified retrospective approach. It measures the right-of-use asset based on the amount of the lease liability and takes the practical expedient that permits it not to recognise initial direct costs (see our Leases: Transition Options publication).

On 1 January 2019, R recognises a right-of-use asset of 500 and a lease liability of 500.

Is it possible to align the accounting treatment of old and new sale-and-leasebacks?

No. IFRS 16 provides two significant reliefs for existing sale-and-leasebacks on transition. Because these reliefs are not optional, there is no opportunity for a seller-lessee to fully align the accounting treatment of sale-and-leaseback transactions entered into before and after the date of initial application of the new standard.

- Under the first relief, a company does not assess whether an existing sale-and-leaseback qualifies for sale-and-leaseback accounting on transition – i.e. it does not assess whether the sale leg would meet the criteria to be recognised as a sale under IFRS 15. This is an important relief because it eliminates the possibility that the company might be required to account for an existing sale-and-leaseback as a financing under IFRS 9. This relief applies to seller-lessees and to buyer-lessors.
- Under the second relief, a seller-lessee does not apply the partial gain recognition approach to sale-and-leaseback transactions entered into before the date of initial application. This decision was intended to simplify transition for companies that have many such transactions at the date of initial application.

In other respects, the transition requirements for the leaseback leg of a sale-and-leaseback transaction are consistent with the general transition requirements for all leases. As a result, an existing sale-and-leaseback will generally come on-balance sheet for the seller-lessee through applying the new lease accounting model to the leaseback. The only exceptions will be leasebacks to which the recognition exemptions apply (See 'Do IFRS 16's recognition exemptions apply to the leaseback?').

Does a seller-lessee reassess an old sale-and-leaseback transaction if it is modified after the date of initial application of IFRS 16?

No. Even if there is a modification to a contract subsequently, a company does not reassess sale-and-leaseback transactions entered into before the date of initial application to determine whether a sale occurred under IFRS 15. Instead, the company accounts for the modification prospectively in accordance with the modification requirements in IFRS 16.

3 Lessee accounting

Specific guidance determines the gain or loss recognised on a sale-and-leaseback transaction and the initial carrying amount of the right-of-use asset.

3.1 Accounting model for lessees

IFRS 16.100, BC 266

If a sale-and-leaseback transaction qualifies as a sale (see Section 2), then the seller-lessee measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset relating to the right of use retained by the seller-lessee.

This means that the amount of any gain or loss recognised by the seller-lessee is limited to the proportion of the total gain or loss relating to the rights transferred to the buyer-lessor. This reflects the economics of the transaction – i.e. the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback.

	Accounting for the seller/lessee
Transfer to buyer-lessor is a sale[1]	• Derecognise the underlying asset and apply the lessee accounting model to the leaseback. • Measure the right-of-use asset at the retained portion of the previous carrying amount (i.e. at cost). • Recognise only the amount of any gain or loss related to the rights transferred to the lessor.
Transfer to buyer-lessor is not a sale	• See Section 5.

Note:

[1] Adjustments are required if the sale is not at fair value or lease payments are off-market.

Example 6 – Sale-and-leaseback transaction is a sale with on-market terms

IFRS 16.IE11

Company C sells an office building to Company D for cash of 1,000,000 (the fair value of the building at that date). Immediately before the transaction, the building is carried at a cost of 500,000. At the same time, C enters into a contract with D for the right to use the building for 15 years with annual payments (which are at market rates) of 80,000 payable at the end of each year. The transfer of the office building qualifies as a sale under IFRS 15. C's incremental borrowing rate is 5.0% per annum. The present value of the annual payments is 830,400, corresponding to 15 annual payments of 80,000 discounted at 5.0% per annum.

C determines that an appropriate method to determine the portion of the rights retained is to compare the present value of the lease payments with the fair value of the asset.

C recognises the transaction as follows.

- C measures the right-of-use asset retained through the leaseback of the office building as a proportion of its previous carrying amount – i.e. 415,200 (830,400 / 1,000,000 x 500,000).

- The total gain on the sale of the building amounts to 500,000 (1,000,000 – 500,000), of which:
  - 415,200 (830,400 / 1,000,000 × 500,000) relates to the right to use the office building retained by C; and
  - 84,800 ((1,000,000 – 830,400) / 1,000,000 × 500,000) relates to the rights transferred to D.
- C recognises a gain of 84,800, which is the portion of the gain on sale that relates to the rights transferred to D.

At the leaseback commencement date, C records the following entries.

	Debit	Credit
Cash	1,000,000	
Right-of-use asset	415,200	
Building		500,000
Lease liability		830,400
Gain on sale-and-leaseback		84,800
To recognise sale-and-leaseback		

Is it possible to still achieve off-balance sheet accounting for a sale-and-leaseback?

No. IFRS 16 ends sale-and-leasebacks as a method for achieving off-balance sheet accounting.

Under the previous standard, IAS 17, the accounting for a sale-and-leaseback transaction depended on the type of lease involved. If the leaseback qualified as an operating lease under that standard, and the lease payments and sale price were at fair value, then the transaction was recorded as a normal sale transaction and the total profit or loss was recognised immediately. This provided a structuring opportunity for companies to recognise gains by moving assets off-balance sheet while continuing to use them.

Under IFRS 16, this is no longer possible and the seller-lessee:

- generally recognises the lease on its balance sheet (unless the leaseback is a short-term or low-value asset, see below); and
- recognises a gain only for the portion of the asset transferred to the buyer-lessor.

Do IFRS 16's recognition exemptions apply to the leaseback?

IFRS 16.A, 5

Yes. Under IFRS 16, seller-lessees can apply the recognition exemptions to the leaseback – i.e. the lease element of a sale-and-leaseback transaction. If a seller-lessee elects to apply the short-term lease recognition exemption for the applicable class of underlying asset transferred, then that election applies when accounting for the short-term leaseback.

The recognition exemptions cover:

- leases with a lease term of 12 months or less that do not contain a purchase option (i.e. short-term leases); and
- leases for which the underlying asset is of low value when it is new.

In practice, these exemptions are unlikely to be relevant to typical 'big-ticket' sale-and-leaseback transactions. Nevertheless they could affect, for example, a short-term sale-and-leaseback transaction that spans two different accounting periods, or one involving the sale and leaseback of a portfolio of low value assets that are material in aggregate – e.g. the sale and leaseback of a large number of laptop computers.

Using the recognition exemptions does not affect IFRS 16's requirements on:

- measuring the right-of-use asset arising from the leaseback; and
- recognising only the amount of the gain or loss that relates to the rights transferred to the buyer-lessor. The seller-lessee accounts for the gain or loss relating to the rights retained by adjusting its lease expense.

3.2 Adjusting for off-market terms

IFRS 16.101

IFRS 16 requires that if the sale-and-leaseback transaction is not on market terms, then a company:

- recognises the sale proceeds at fair value; and
- accounts for any below-market terms as a prepayment of lease payments and any above-market terms as additional financing provided by the buyer-lessor to the seller-lessee.

IFRS 16.102

A company measures any potential adjustment required for off-market terms on the basis of the more readily determinable of:

- the difference between the fair value of the consideration for the sale and the fair value of the underlying asset; and
- the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

Is it always necessary to adjust for off-market terms?

IFRS 16.BC267

Yes. In a sale-and-leaseback transaction, the lease payments and the sale price are typically negotiated together and are, therefore, interdependent. For example, if the rentals under the leaseback are above market rate, then the sale price under the contract might be set at a value that exceeds the asset's fair value to reflect this. Conversely the sale price might be less than the asset's fair value because the leaseback rentals are below market rate. Therefore, using the contractual amounts to account for the transaction could result in a misstatement of:

- gains or losses on disposal of the asset, as well as financial liabilities and interest expense (if the sale price exceeds fair value) or right-of-use assets and depreciation thereof (if the sale price is less than fair value) for the seller-lessee; and
- the carrying amount of the asset and leaseback rental income for the buyer-lessor.

Example 7 – Sale-and-leaseback transaction is a sale with off-market terms

IFRS 16.IE11

Company C sells an office building to Company D for cash of 1,000,000. Immediately before the transaction, the building is carried at a cost of 500,000. At the same time, C contracts with D for the right to use the building for 15 years with annual payments of 80,000 payable at the end of each year. The transfer of the office building qualifies as a sale under IFRS 15. C's incremental borrowing rate is 5.0% per annum.

The fair value of the office building on the date of sale is 900,000. Because the consideration for the sale of the office building exceeds its fair value, C makes adjustments to recognise the transaction at fair value. The amount of the excess sale price of 100,000 (1,000,000 – 900,000) is recognised as additional financing provided by D to C.

The present value of the annual payments is 830,400. Of this amount, 100,000 relates to the additional financing and 730,400 relates to the lease – corresponding to 15 annual payments of 9,634 and 70,366, respectively, when discounting at 5.0% per annum.

C determines that an appropriate method to determine the portion of the rights retained is to compare the present value of the lease payments with the fair value of the asset.

C recognises the transaction as follows.

- C measures the right-of-use asset retained through the leaseback of the office building as a proportion of its previous carrying amount – i.e. 405,778 (730,400 / 900,000 × 500,000).
- The total gain on the sale of the building amounts to 400,000 (900,000 – 500,000), of which:
  - 324,622 (730,400 / 900,000 × 400,000) relates to the right to use the office building retained by C; and
  - 75,378 ((900,000 – 730,400) / 900,000 × 400,000) relates to the rights transferred to D.
- C recognises a gain on sale of 75,378, which is the portion of the gain on sale that relates only to the rights transferred to D.

At the lease commencement date, C records the following entries.

	Debit	Credit
Cash	1,000,000	
Right-of-use asset	405,778	
Building		500,000
Financial liability		830,400*
Gain on sale-and-leaseback		75,378
To recognise sale-and-leaseback		

Note:

* Comprising 730,400 relating to the lease and 100,000 related to the additional financing.

Section 6 discusses the impact of forthcoming requirements on the classification of these amounts.

After the lease commencement date, C accounts for the annual payments of 80,000 as follows.

- C recognises 70,366 as lease payments.
- C accounts for the remaining 9,634 as payments to repay the financial liability of 100,000 and interest expense.

Is a company required to maximise the use of observable prices and information when determining the formula to use in measuring the potential adjustment for off-market terms?

No. Under IFRS 16, a company measures any potential adjustment using the more readily determinable of the difference between:

- the fair value of the sale price and the fair value of the asset; and
- the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

These comparisons may yield different results, but a company can use either to identify whether it needs to adjust the accounting for the transaction for off-market terms.

Using observable prices and information to determine fair value and deciding which formula to use is consistent with IFRS 13 *Fair Value Measurement*. However, IFRS 16 contains its own definition of fair value for lessors; IFRS 13 does not apply to lease transactions.

3.3 Leaseback with variable payments

IFRS 16.100, IU 06-20 The payments for the lease in a sale-and-leaseback transaction may be fully variable depending on sales or usage. In these cases, a question arises on how to measure the right-of-use asset arising from the leaseback and how to determine the amount of any gain or loss to be recognised at the date of the transaction. The IFRS Interpretations Committee discussed this issue and noted that a seller-lessee applies the requirements of paragraph 100 of IFRS 16 to measure the right-of-use asset arising from the leaseback (see also Section 6 on forthcoming requirements). That is, the seller-lessee measures the right-of-use asset at the proportion of the previous carrying amount of the asset relating to the right of use retained. In doing so, the seller-lessee compares the right of use retained to the rights relating to the underlying asset it held before the sale-and-leaseback transaction.

IFRS 16.100, IU 06-20 If a gain or loss relating to the rights transferred to the buyer-lessor arises, then this is determined using the same proportion as for measuring the right-of-use asset. The seller-lessee also recognises a liability. The initial measurement of this liability will vary according to how the seller-lessee measures the right-of-use asset and determines the gain or loss arising on the transaction.

Example 8 – Sale-and-leaseback transaction with variable payments

IFRS 16.100, IU 06-20 Company C sells an office building to Company D for 900,000 (the fair value of the building at that date). Immediately before the transaction, the building is carried at a cost of 500,000. The transfer of the office building qualifies as a sale under IFRS 15. At the same time, C contracts with D for the right to use the building for five years. All the payments for the lease are variable, calculated as a market-rate percentage of C's revenue generated from using the building during the five-year lease term. At the date of the transaction, the present value of the expected payments for the lease is 225,000. There are no initial direct costs.

C determines that it is appropriate to calculate the proportion of the building relating to the right of use retained using the present value of the expected payments for the lease. On this basis, the proportion of the building that relates to the right of use retained is 25% (225,000 / 900,000). Consequently, the proportion of the office building that relates to the rights transferred to D is 75% (900,000 – (225,000 / 900,000)).

C recognises the transaction as follows.

- C measures the right-of-use asset retained through the leaseback of the office building as a proportion of its previous carrying amount – i.e. 125,000 (225,000 / 900,000 × 500,000).
- The total gain on the sale of the building amounts to 400,000 (900,000 – 500,000), of which:
  - 100,000 (225,000 / 900,000 × 400,000) relates to the right to use the office building retained by C; and
  - 300,000 ((900,000 – 225,000) / 900,000 × 400,000) relates to the rights transferred to D.

C recognises a gain of 300,000 – i.e. the portion of the total gain that relates only to the rights transferred to D. At the commencement date, C records the following entries.

	Debit	Credit
Cash	900,000	
Right-of-use asset	125,000	
Building		500,000
Liability		225,000
Gain on sale-and-leaseback		300,000
To recognise sale-and-leaseback		

Does IFRS 16 prescribe a method for determining the proportion of the previous carrying amount of the asset that relates to the right of use retained?

No. Depending on the facts and circumstances, potential methods that may be appropriate include comparing:

- the present value of expected payments for the leaseback (including those that are variable) with the fair value of the underlying asset at the date of the transaction;
- for a transaction involving a building, the amount of floor space retained under the leaseback arrangement with the amount of floor space before entering into the arrangement; and
- the leaseback term relative to the total period of use of the underlying asset.

Can the right-of-use asset be zero in a leaseback with variable payments?

IFRS 16.100, IU 06-20

No. The seller-lessee's right-of-use asset in a leaseback with variable payments is not measured at zero at the date of the transaction, because this would not reflect the proportion of the previous carrying amount of the asset relating to the right of use retained by the seller-lessee.

Is the resulting credit necessarily a lease liability?

It depends. Whether the liability is a lease liability depends on whether the seller-lessee has adopted the September 2022 amendments to IFRS 16 *Lease Liability in a Sale and Leaseback*.

When the IFRS Interpretations Committee discussed the accounting for a leaseback with variable terms, the Committee did not describe the liability as a lease liability. If it had done so, it would have meant that a seller-lessee could have recognised a gain on the right of use it retains through mechanical application of the subsequent measurement requirements for lease liabilities – e.g. following a lease modification or change in the lease term.

For example, variable lease payments that do not depend on an index or rate are excluded from IFRS 16's definition of lease payments. This means that applying IFRS 16's remeasurement guidance to a leaseback involving such payments could result in a seller-lessee recognising a gain, even though no transaction or event would have occurred.

In contrast, the September 2022 amendments specify that the liability is a lease liability. This is because the September 2022 amendments require a seller-lessee to subsequently measure lease liabilities arising from a leaseback in such a way that it does not recognise any amount of the gain or loss that relates to the right of use it retains (see Section 6).

4 Lessor accounting

In a sale-and-operating leaseback transaction, the buyer-lessor recognises the underlying asset and an operating lease to the seller-lessee, and adjusts for any off-market components.

4.1 Accounting model for lessors

IFRS 16.100(b)

If a sale-and-leaseback transaction qualifies as a sale (see Section 2), the buyer-lessor recognises the underlying asset under applicable IFRS Accounting Standards and applies the lessor accounting model in IFRS 16 to the leaseback.

	Accounting for the buyer-lessor
Transfer is a sale[1]	• Recognise the underlying asset and apply the lessor accounting model to the leaseback.
Transfer is not a sale	• See Section 5.

Note:

[1] Adjustments are required if the sale is not at fair value or lease payments are off-market.

Example 9 – On-market sale-and-leaseback transaction

Assume the same facts as in Example 6.

D recognises the underlying asset (building) at cost under applicable IFRS Accounting Standards (IAS 16 or IAS 40). Therefore, at the commencement date, D records the following entries.

	Debit	Credit
Building	1,000,000	
Cash		1,000,000

D then applies IFRS 16's lessor accounting model to the leaseback.

D first assesses whether the lease is a finance lease or an operating lease. If D concludes that the lease is an operating lease, then D will continue to recognise the building as an asset measured under either IAS 16 or IAS 40.

D recognises the lease payments from C as income over the leaseback term on a straight-line basis, or another systematic basis if that is more representative of the pattern in which it derives benefit from using the underlying asset.

Do lessors apply the lease classification test?

IFRS 16.61-66

Yes. After recognising the underlying asset under applicable IFRS Accounting Standards, the buyer-lessor applies IFRS 16's lessor accounting model to the leaseback. This includes the lease classification test in paragraphs 61 to 66. Therefore, the lessor's subsequent accounting differs depending on whether it classifies the leaseback as an operating lease or a finance lease.

As noted in Section 2, classifying the leaseback as a finance lease does not preclude the possibility that sale-and-leaseback accounting applies. The lease classification depends on the facts and circumstances and the terms of the leaseback.

4.2 Adjusting for off-market terms

IFRS 16.101

IFRS 16 requires that if the fair value of the consideration for the sale of the asset in a sale-and-leaseback transaction is not equal to the fair value of the asset, or if the lease payments are not at market rates, then a company:

- recognises the sale proceeds at fair value; and
- accounts for any below-market terms as a prepayment of lease payments, and any above-market terms as additional financing provided by the buyer-lessor to the seller-lessee.

IFRS 16.102

A company measures any potential adjustment required for off-market terms on the basis of the more readily determinable of the difference between:

- the fair value of the sale price and the fair value of the underlying asset; and
- the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

Example 10 – Sale-and-leaseback transaction in a sale with off-market terms

Assume the same facts as in Example 7.

D recognises the underlying asset (building) at fair value of the sale proceeds (900,000) and accounts for the above-market terms (100,000) as additional financing that it provides to C. Therefore, at the commencement date, D records the following entries.

	Debit	Credit
Building	900,000	
Financial asset	100,000	
Cash		1,000,000

After the commencement date, D accounts for the annual payments of 80,000 as follows:

- D recognises 70,366 as lease payments.
- D accounts for the remaining 9,634 as payments received to settle the financial asset of 100,000 and interest revenue.

5 Accounting for failed sales

The seller-lessee and the buyer-lessor account for failed sales as financing arrangements under IFRS 9.

5.1 Basic requirement

IFRS 16.103

If the transfer of an asset in a sale-and-leaseback arrangement is a failed sale – i.e. it does not satisfy the requirements in IFRS 15 to be accounted for as an asset sale – then the seller-lessee continues to recognise the transferred asset and recognises a financial liability equal to the transfer proceeds. It accounts for the financial liability subsequently under IFRS 9.

Similarly, the buyer-lessor does not recognise the transferred asset. Instead, it recognises a financial asset equal to the transfer proceeds and accounts for that asset subsequently under IFRS 9.

Example 11 – Sale-and-leaseback transaction is a failed sale

Company C sells a commercial building to Company D for cash. C also contracts with D for the right to use the building for 15 years with annual payments payable at the end of each year. The contract contains a clause that gives C a substantive option to repurchase the building from D at its fair value.

The transfer of the building does not meet the criteria in IFRS 15 to be accounted for as a sale of the transferred asset. This is because C's option to repurchase the building means that it has not transferred control of the building to D. Accordingly, C continues to recognise the building and recognises a financial liability equal to the amount of the transfer proceeds received. C accounts for the financial liability subsequently under IFRS 9.

D does not recognise the building as its asset but instead recognises a financial asset equal to the transfer proceeds.

Does the accounting by a seller-lessee differ substantially between a failed sale and a successful sale?

Yes. Although the seller-lessee will recognise a liability for its obligation to make payments to the buyer-lessor under both failed-sale accounting and sale-and-leaseback accounting, there are two key differences.

Firstly, the seller-lessee will not recognise a gain or loss on the date of a failed sale. In contrast, under sale-and-leaseback accounting a seller-lessee will generally recognise a gain or loss on the rights transferred.

Secondly, the subsequent measurement requirements differ for a financial liability arising from a failed sale, which is measured under IFRS 9, and a lease liability arising from sale-and-leaseback accounting. Many common features of lease liabilities – e.g. renewal and termination options, purchase options and variable lease payment mechanisms – may be complex to account for under IFRS 9. Lease liabilities, including lease liabilities arising from sale-and-leaseback transactions, are outside the scope of IFRS 9 for measurement purposes.

5.2 More complex scenarios

IFRS 9.A

IFRS 9 is silent on how to subsequently measure the amortised cost of the financial liability. If there is no embedded derivative that is separated, then in our view a company calculates the effective interest rate on initial recognition of the financial liability by estimating future cash payments and considering:

- the expected lease payments over the expected term of the leaseback (excluding any portion representing compensation to the lessor for costs relating to the asset – e.g. maintenance); and
- expectations relating to the final cash flow to settle the liability. This may be the option exercise price if the asset is expected to be repurchased. However, if the asset is expected to be surrendered to the buyer-lessor, then this may be the expected fair value of the underlying asset at the end of the leaseback period.

IFRS 9.B5.4.6

In our view, if during the contractual term the company's expectations change about exercising the purchase option, then it should revise the estimated cash flows, adjust the amortised cost of the financial liability and recognise the adjustment in profit or loss.

Example 12 – Determining contractual cash flows for a failed-sale financial liability in a sale-and-leaseback arrangement

On 1 January 2022, Company K enters into a sale-and-leaseback transaction for a vessel. The arrangement contains a substantive repurchase option, and therefore is a failed sale under IFRS 15. The details of the transaction are as follows.

- K receives cash proceeds of 1,250 at the start of the arrangement.
- The contractual period is five years.
- Annual payments of 220 are payable at the end of each year.
- The annual payments do not include any amounts that represent compensation to the lessor for costs relating to the asset.
- The agreement gives K an option to repurchase the vessel at the end of the arrangement for a fixed price of 670 and it is K's intention to exercise the option.

At the start of the arrangement, K recognises a financial liability of 1,250 for the proceeds received. K determines on initial recognition that the expected future cash flows are as follows.

- Annual cash outflows of 220.
- A cash outflow of 670 at the end of year five.

Based on these estimated cash flows, K calculates the effective interest rate as 10% and uses this rate to recognise interest expense during the period of the arrangement as follows.

Date	Annual payment	Interest	Carrying amount of liability
1 January 2022	–	–	1,250
31 December 2022	220	125	1,155
31 December 2023	220	116	1,051
31 December 2024	220	105	936
31 December 2025	220	93	809
31 December 2026	220	81	670
Total	1,100	520	

At the end of the contractual term, K exercises the repurchase option as expected and settles the liability by paying the option exercise price of 670.

Is a failed sale always accounted for at fair value on initial recognition?

IFRS 16.103; IFRS 9.B5.1.1

No. If the transfer of the asset is not a sale, then IFRS 16 requires the seller-lessee to recognise a financial liability, and the buyer-lessor a financial asset, equal to the transfer proceeds. This contrasts with the requirements in IFRS 9. Under IFRS 9, if part of the consideration given or received is for something other than the financial instrument, then a company does not measure the financial instrument at its transaction price but instead at its fair value.

6 Forthcoming requirements

Amendments to IFRS 16 introduce a new accounting model for variable payments in sale-and-leaseback transactions entered into since 2019.

6.1 Initial measurement

IFRS 16. 102A

In September 2022, the IASB issued amendments to IFRS 16 *Lease Liability in a Sale and Leaseback*, which are effective from 1 January 2024. The amendments do not introduce new requirements for initial measurement of the right-of-use asset and lease liabilities arising from a sale-and-leaseback transaction. On initial recognition, the seller-lessee measures the right-of-use asset as a proportion of the carrying amount of the underlying asset and includes variable lease payments when it measures a liability arising from a sale-and-leaseback transaction.

IFRS 16.IE11,12

However, the amendments have added a new illustrative example which clarifies that:

- a seller-lessee may adopt different approaches to determining the lease payments on initial recognition; and
- the obligation to make variable payments over the term of the leaseback is a lease liability.

The amendments include examples illustrating two different approaches for determining the lease payments. Both approaches ensure that the seller-lessee will not recognise any amount of the gain or loss relating to the right of use retained. Examples 13 and 14 illustrate the two approaches.

Example 13 – Sale-and-leaseback transaction with variable payments: Expected lease payments (Approach 1)

Company Z transfers an office building to Company Y for 900,000 (fair value of the office building at the date of sale). Immediately before the transaction, the carrying amount of the building is 500,000. At the same time, Z enters into a contract with Y for the right to use the building for six years, with annual lease payments that comprise variable payments that do not depend on an index or rate. The transfer of the office building qualifies as a sale under IFRS 15. Z's incremental borrowing rate is 4% per annum.

Expected lease payments at the commencement date

Z assesses that although the lease payments are variable, it can make a reasonable estimate of the lease payments for the term of the leaseback. Therefore, it determines the lease payments as the amounts it expects to pay over the lease term as follows.

Year	Lease payments
1	48,000
2	50,000
3	51,000
4	52,000
5	54,000
6	55,000

Z calculates that the present value of the lease payments discounted at its incremental borrowing rate is 270,000.

At the commencement date, Z determines the proportion of the building transferred to Y that relates to the right of use it retains. To do this, Z compares the present value of the expected lease payments of 270,000 to the fair value of the building of 900,000. That is, Z calculates the proportion of the rights retained as 270,000 / 900,000 x 100 = 30%. Using this percentage, Z calculates the initial carrying amount of the right-of-use asset as 150,000 (30% × 500,000 (the previous carrying amount of the building)).

Z notes that the gain on sale can be derived as a balancing figure. Alternatively, it can calculate it by applying the percentage of the rights transferred (70%) to the gain that would have arisen in the absence of the leaseback – i.e. the proceeds of 900,000 less the carrying amount of the building of 500,000. This gives a gain of 280,000 (70% × (900,000 - 500,000)).

At the commencement date, Z accounts for the sale-and-leaseback transaction as follows.

	Debit	Credit
Cash	900,000	
Right-of-use asset (500,000 x 30%)	150,000	
Building		500,000
Lease liability		270,000
Gain on sale-and-leaseback (70% x (900,000 – 500,000))		280,000
To recognise sale-and-leaseback		

The expected amortisation schedules for the lease liability and right-of-use asset are as follows.

Lease liability

Year	Opening balance	Lease payments[a]	Interest expense[b] (4% p.a.)	Closing balance
1	270,000	(48,000)	10,800	232,800
2	232,800	(50,000)	9,312	192,112
3	192,112	(51,000)	7,684	148,796
4	148,796	(52,000)	5,952	102,748
5	102,748	(54,000)	4,110	52,858
6	52,858	(54,973)[c]	2,114	–

Right-of-use asset

Year	Opening balance	Depreciation[d]	Closing balance
1	150,000	(25,000)	125,000
2	125,000	(25,000)	100,000
3	100,000	(25,000)	75,000
4	75,000	(25,000)	50,000
5	50,000	(25,000)	25,000
6	25,000	(25,000)	–

Notes:

(a) Z reduces the carrying amount of the lease liability by the lease payments. These lease payments reflect the expected lease payments that it estimated at the commencement date and which, when discounted, result in the carrying amount of the lease liability at that date of 270,000.

(b) Z increases the carrying amount of the lease liability to reflect interest on the lease liability using the incremental borrowing rate of 4% per annum.

(c) The estimated amount of 55,000 was adjusted to 54,973 for rounding purposes when preparing the lease amortisation schedule.

(d) Z amortises the right-of-use asset on a straight-line basis over the lease term.

Example 14 – Sale-and-leaseback transaction with variable payments: Equal lease payments over the lease term (Approach 2)

Equal lease payments over the lease term

Assume the fact pattern from Example 13 above, except that in this case Z does not believe it can make a reasonable estimate of the expected lease payments.

Instead, Z assesses that it can determine the proportion of the rights retained under the leaseback using another approach (see Section 3.3).

Z determines the proportion of the rights retained to be 33%. Using this percentage, it calculates that the initial carrying amount of the right-of-use asset is 165,000 (33% × 500,000). Z also calculates the gain arising on commencement of the sale-and-leaseback to be 268,000 (67% × (900,000 – 500,000)).

At the commencement date, Z accounts for the sale-and-leaseback transaction as follows.

	Debit	Credit
Cash	900,000	
Right-of-use asset (500,000 x 33%)	165,000	
Building		500,000
Lease liability		297,000
Gain on sale-and-leaseback (67% x (900,000 – 500,000))		268,000
To recognise sale-and-leaseback		

Z then determines the lease payments as the equal periodic payments over the lease term that, when discounted using the 4% per annum incremental borrowing rate, result in the initial carrying amount of the lease liability of 297,000. This gives a constant annual lease payment of 56,656.

The expected amortisation schedules for the lease liability and right-of-use asset are as follows.

Lease liability

Year	Opening balance	Lease payments[a]	Interest expense[b] (4% p.a.)	Closing balance
1	297,000	(56,656)	11,880	252,224
2	252,224	(56,656)	10,089	205,656
3	205,656	(56,656)	8,226	157,226
4	157,226	(56,656)	6,289	106,859
5	106,859	(56,656)	4,274	54,477
6	54,477	(56,656)	2,179	0

Right-of-use asset

Year	Opening balance	Depreciation	Closing balance
1	165,000	(27,500)	137,500
2	137,500	(27,500)	110,000
3	110,000	(27,500)	82,500
4	82,500	(27,500)	55,000
5	55,000	(27,500)	27,500
6	27,500	(27,500)	0

Notes:

(a) Z increases the carrying amount of the lease liability to reflect interest on the lease liability using the incremental borrowing rate of 4% per annum.

(b) Z reduces the carrying amount of the lease liability with lease payments that reflect equal periodic payments over the lease term. These payments, when discounted, result in the carrying amount of the lease liability at the commencement date of 297,000.

What kinds of variable payments do the amendments capture?

The amendments do not distinguish between different types of variable payment. Instead, they introduce a general requirement that when a seller-lessee applies the subsequent measurement requirements for the lease liability, it does not recognise a gain or loss relating to the right of use it retains under the leaseback.

In practice, the significance of the amendments may differ for different types of variable payment and depend on how a company determined the lease payments at the commencement date.

For example, in a sale and leaseback of renewable power assets, it is possible that all of the lease payments are variable – i.e. they depend on the output of the underlying asset. In these cases, it will be important to ensure that the seller-lessee determines the lease payments and applies the subsequent measurement requirements under the amendments.

Conversely, in a sale and leaseback of real estate in the retail sector, it is possible that there will be a high proportion of fixed payments and only a small proportion of variable payments. In these cases, a company may need to apply judgement in assessing whether it is acceptable to determine the lease payments to be the fixed payments only. This may be appropriate if it expects the variable payments to be very small.

Why do the amendments include two approaches?

Including two approaches for subsequent measurement of sale-and-leaseback transactions appears to be in response to stakeholder feedback on the IASB's exposure draft (ED), which was more prescriptive.

At the ED stage, the IASB had proposed a single approach of estimating expected variable payments to measure the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. However, some stakeholders believed that this approach would introduce a high degree of estimation uncertainty, particularly for long-term leases and/or in unstable markets, because it would require companies to predict future payments.

The final amendments are less prescriptive and illustrate two approaches, but they retain the core requirement that variable lease payments are included in a lease liability arising from a sale-and-leaseback transaction.

Is the credit always a lease liability?

Yes. The credit that the seller-lessee recognises is a lease liability and is labelled as such in the new illustrative examples. The credit represents an obligation to make payments in consideration for the right to use the transferred asset, which is measured – and remeasured – under IFRS 16.

Previous literature did not specify that the credit was a lease liability. For example, IFRS 16 originally labelled the credit as a financial liability, and the Committee's agenda decision did not specify the precise nature of the liability. Some Committee members expressed concern that if the credit were specifically identified as a lease liability, then applying the subsequent measurement requirements in IFRS 16 would result in inappropriate recognition of a gain.

The amendments clarify both that the credit is a lease liability and that the seller-lessee applies the subsequent measurement requirements in IFRS 16 such that it does not recognise a gain or loss associated with the right of use it retains.

6.2 Subsequent measurement

IFRS 16. 102A

Under the amendments, a seller-lessee will apply the subsequent measurement requirements for lease liabilities such that it recognises no gain or loss on the right of use it retains.

IFRS 16. IE25

The difference between the actual lease payments made and the lease payments that reduce the carrying amount of the lease liability are recognised in profit or loss.

Example 15 – Difference between actual and expected payments in profit or loss

Assume the same facts as in Example 13. On lease commencement, Z determined the lease payments under the expected lease payments approach to calculate the lease liability (Approach 1).

The actual lease payments paid by Z over the lease term differ from the lease payments determined on lease commencement. Therefore, Z recognises in profit or loss the difference between the lease payments determined on lease commencement and its actual lease payments as follows.

Year	Actual lease payments	Lease payments determined on commencement	Difference recognised in profit or loss Debit/(Credit)
1	46,000	48,000	(2,000)
2	47,000	50,000	(3,000)
3	52,500	51,000	1,500
4	54,000	52,000	2,000
5	52,000	54,000	(2,000)
6	50,000	55,000	(5,000)

If Z had used Approach 2 to determine the lease payments on lease commencement (as illustrated in Example 14), the same principle would apply on subsequent measurement. That is, Z does not reassess the lease liability if the expected variable lease payment changes after initial recognition due to changes in expectations. The difference between actual and expected lease payments is recognised in profit or loss as illustrated in the table above.

The remaining examples in this section illustrate how to apply the subsequent measurement requirements to more complex scenarios. In each case, the core principles underlying the calculations are that:

- the lease payments determined on lease commencement are not revised for changes in expectations; and
- the seller-lessee does not recognise a gain or loss that relates to rights retained under the leaseback, unless there is a partial or full termination.

Example 16 illustrates a lease modification and Example 17 illustrates a reassessment of the lease term. In these examples, there is no partial or full termination and, therefore, the lease payments determined on lease commencement are not revised for changes in expectations.

Example 18 illustrates a lease termination. In this example, a reduction in the rights retained results in a gain being recognised in profit or loss.

Example 16 – Lease modification

IFRS 16.45(c)

Company X transfers a power plant to Company B at fair value of 700,000. The carrying amount of the power plant immediately before the transfer is 500,000. The transfer of the power plant qualifies as a sale under IFRS 15. At the same time, X enters into a new contract with B for the right to use the power plant for a period of five years with an option to terminate the lease after four years. X determines that it is reasonably certain not to exercise the termination option, such that the lease term is five years.

The lease payments include fixed and variable amounts depending on the output of the power plant. X's incremental borrowing rate is 3% per annum.

On lease commencement, X determines the lease payments using the expected lease payments (Approach 1) for the five-year lease term as follows.

Year	Fixed lease payment	Variable lease payment
1	20,000	25,000
2	20,000	28,000
3	20,000	30,000
4	20,000	32,000
5	20,000	35,000

The present value of the fixed and estimated variable lease payments shown in the table above discounted at X's incremental borrowing rate of 3% is 228,336.

At the lease commencement date, X determines the proportion of the power plant transferred to B that relates to the right of use it retains. To do this, X compares the present value of the expected lease payments of 228,336 to the fair value of the power plant of 700,000. X calculates the proportion of the rights retained as 32.6% (228,336 / 700,000 × 100). Using this percentage, X calculates the initial carrying amount of the right-of-use asset as 163,097 (32.6% × previous carrying amount of the power plant (500,000)).

At the lease commencement date, X accounts for the sale-and-leaseback as follows.

	Debit	Credit
Cash	700,000	
Right-of-use asset (500,000 x 32.6%)	163,097	
Power plant		500,000
Lease liability		228,336
Gain on sale-and-leaseback (67.4% x (700,000 – 500,000))		134,761
To recognise sale-and-leaseback		

At the end of Year 1, X and B modify the lease and agree that X will not be required to make fixed lease payments in Year 2 and Year 3. At the same time, the termination option is removed from the lease.

This is a lease modification that X does not account for as a separate lease. Instead, X remeasures the lease liability using the revised lease payments and revised incremental borrowing rate and adjusts the carrying amount of the right-of-use asset.

X's incremental borrowing rate at the date of lease modification is 3.5% per annum. The pre-modification carrying amount of the lease liability and right-of-use asset are 190,186 and 130,478.

To account for the lease modification, X determines which lease payments to include in the revised lease liability. It notes that under the general measurement model for lease liabilities, it would not include variable lease payments that depend on sales or usage. However, it also notes that:

- the lease liability arose in a sale-and-lease back transaction;
- the lease payments determined on lease commencement are not revised for changes in expectations;
- the lease modification does not change its obligation to make variable lease payments; and
- excluding the variable lease payments from the lease liability would result in recognition of a gain associated with the rights retained under the leaseback.

Therefore, X revises the lease payments on remeasurement of the modified lease liability as follows.

Year	Fixed lease payments	Variable lease payments
1	–	28,000
2	–	30,000
3	20,000	32,000
4	20,000	35,000

X measures the revised lease liability by discounting the lease payments shown in the table above at its revised incremental borrowing rate of 3.5%. This results in a lease liability of 149,889.

X recognises the difference between the carrying amounts of the lease liability before the modification and the modified lease liability of 40,297 (190,186 – 149,889) as an adjustment to the right-of-use asset. At the date of modification, X records the following journal entry.

	Debit	Credit
Lease liability	40,297	
Right-of-use asset		40,297

Example 17 – Change in lease term

Company C transfers a machine to Company D for 500,000, which is also the fair value of the machine on the date of transfer. The carrying amount of the machine immediately before the transfer is 400,000. The estimated useful life of the machine is 10 years. The transfer of the machine qualifies as a sale under IFRS 15.

At the same time, C enters into a contract with D for the right to use the machine for a period of four years. The lease payments include fixed payments of 25,000 per annum and variable amounts depending on the units of production. C's incremental borrowing rate is 4% per annum. The contract also contains an option to renew the lease for an additional three years on the same payment terms. However, C determines that it is not reasonably certain to exercise the renewal option at the lease commencement date and, therefore, the lease term is four years.

C determines the fixed and variable lease payments under the expected lease payments approach as follows.

Year	Fixed lease payment	Variable lease payment
1	25,000	20,000
2	25,000	22,000
3	25,000	24,000
4	25,000	26,000

The present value of the fixed and estimated variable lease payments shown in the table discounted at C's incremental borrowing rate of 4% is 173,879.

At the lease commencement date, C determines the proportion of the machine transferred to D that relates to the right of use it retains. To do this, C compares the present value of the expected lease payments of 173,879 to the fair value of the machine of 500,000 and calculates the proportion of the rights retained as 34.8% (173,879/500,000 × 100). Using this percentage, C calculates the initial carrying amount of the right-of-use asset as 139,103 (34.8% x the previous carrying amount of the machine (400,000)).

At the lease commencement date, C accounts for the sale and leaseback of the machine as follows.

	Debit	Credit
Cash	500,000	
Right-of-use asset (400,000 × 34.8%)	139,103	
Machine		400,000
Lease liability		173,879
Gain on sale-and-leaseback (65.2% x (500,000 – 400,000))		65,224
To recognise sale-and-leaseback		

At the end of Year 2, changes in C's production process require C to extend its use of the machine. Therefore, it decides to exercise the renewal option and extend the lease term for another three-year period. Its incremental borrowing rate at that date is 4.5% per annum.

The carrying amount of the lease liability and the right-of-use asset immediately before the exercise of the renewal option are 94,268 and 69,552 respectively.

Exercising the renewal option is treated as a lease reassessment because the renewal option was part of the original contract. C remeasures the lease liability incorporating the lease payments for the remaining period of the revised lease term (using the revised discount rate) and adjusts the right-of-use asset.

To do this, C needs to determine which lease payments to include in the revised lease liability. Under the general measurement model for lease liabilities, C does not include variable lease payments that depend on sales or usage. However, it notes that:

- the lease liability arose in a sale-and-leaseback transaction;
- the lease payments determined on lease commencement are not revised for changes in expectations;
- the lease reassessment does not change its obligation to make variable lease payments up to the end of Year 4;

- excluding the variable lease payments up to the end of Year 4 from the lease liability would result in recognising a gain associated with the rights retained under the leaseback;
- the variable lease payments in Years 5 to 7 do not relate to the rights retained when the sale and leaseback was recognised initially; and
- the fixed lease payments in Years 5 to 7 will be included in the lease liability under the general measurement model for lease liabilities.

Therefore, the lease payments included in remeasuring the lease liability are as follows.

Year	Fixed lease payment	Variable lease payment
3	25,000	24,000
4	25,000	26,000
5	25,000	–
6	25,000	–
7	25,000	–

C measures the revised lease liability by discounting the lease payments shown in the table above at its revised incremental borrowing rate of 4.5%. This results in a lease liability of 156,525.

C recognises the difference between the carrying amount of the lease liability before the reassessment and the carrying amount of the revised lease liability of 62,257 (156,525 - 94,268) as an adjustment to the right-of-use asset. At the reassessment date, C records the following journal entry.

	Debit	Credit
Right-of-use asset	62,257	
Lease liability		62,257

Example 18 – Reduction in scope

Assume the fact pattern in Example 17 above, except that at the end of Year 1, Company C and Company D decide to terminate the lease early – i.e. by the end of Year 3. This is because the machine does not meet C's production process specifications.

C's incremental borrowing rate at the end of Year 1 is 4.5%.

At the end of Year 1, the carrying amount of the right-of-use asset is 104,328 and the lease liability is 135,834.

The original terms and conditions of the leaseback did not include a termination option. Therefore, this is a lease modification that reduces the scope of the lease. At the date of the modification, C remeasures the lease liability for the new lease term.

To do this, C needs to determine which lease payments to include in the revised lease liability. Under the general measurement model for lease liabilities, C does not include variable lease payments that depend on sales or usage. However, it notes that:

- the lease liability arose in a sale-and-leaseback transaction;
- the lease modification does not change C's obligation to make variable lease payments up to the end of Year 3;

- excluding the variable lease payments up to the end of Year 3 from the lease liability would result in recognising a gain associated with the rights retained under the leaseback; and
- as a result of the lease modification, C has reduced the scope of the lease and no longer retains the right to use the machine in Year 4.

Therefore, C recalculates the lease liability using:

- fixed and variable annual lease payments for Year 2 of 25,000 and 22,000 respectively, and for Year 3 of 25,000 and 24,000 respectively;
- a remaining lease term of two years; and
- a revised incremental borrowing rate of 4.5%.

C accounts for the partial termination of the lease by reducing the carrying amount of the right-of-use asset and lease liability by one-third, reflecting the proportionate reduction in scope of the lease (3 years - 2 years/ 3 years) and recognising any resulting gain or loss as follows.

	Pre-modification carrying amount	**Remaining carrying amount after modification (two-thirds)**	**Difference (reduction of one-third)**
Lease liability	135,834	90,496 (present value of two annual lease payments of 47,000 and 49,000 discounted at the original rate of 4%)	(45,338)
Right-of-use asset	104,328	69,552 (104,328 × 66.7%)	(34,776)
Gain on modification			10,562

The difference of 649 between the remaining carrying amount of the lease liability after this step (90,496) and the modified lease liability calculated at the revised discount rate (89,847) is recorded as an adjustment to the right-of-use asset. This reflects the change in the consideration paid for the lease and the revised discount rate.

What's the purpose of the new subsequent measurement requirements?

The core objective of the new subsequent measurement requirements is to prevent inappropriate recognition of gains or losses that do not arise from a transfer or other exchange transactions.

IFRS 16 contains clear requirements that on initial recognition of a sale-and-leaseback transaction a seller-lessee recognises only the gain or loss on the rights transferred to the buyer-lessor. The seller-lessee does not recognise a gain on the rights it retains.

Without the new requirements, a seller-lessee could have recognised a gain on the right of use it retains solely because of a remeasurement – e.g. following a lease modification or a change in the lease term. This could occur in a leaseback that includes lease payments that are excluded from the lease liability under IFRS 16 – e.g. variable lease payments that do not depend on an index or rate. A seller-lessee could have recognised a gain, even though no transaction or event would have occurred to give rise to that gain.

Previously, IFRS 16 did not include any specific subsequent measurement requirements for sale-and-leaseback transactions. These transactions often involve the sale of high value items of property, plant and equipment with a long economic life. Because the accounting for these transactions can have a long-term material effect on the financial position of seller-lessees, it is important that they apply the requirements in IFRS 16 consistently to sale-and-leaseback transactions, both on initial recognition and subsequently.

6.3 Effective date and transition

IFRS 16.C1D, C20E

The amendments are effective for annual reporting periods beginning on or after 1 January 2024.

The amendments will apply retrospectively in accordance with IAS 8 to sale-and-leaseback transactions entered into after the date of initial application of IFRS 16. The date of initial application is the beginning of the annual reporting period in which IFRS 16 was first applied by a company.

A company may apply the amendments early but, if it does, it discloses that fact.

Example 19 – Sale and leaseback entered into under IFRS 16

Company ABC applied IFRS 16 with a date of initial application of 1 January 2019. In February 2019, Company ABC transferred a retail store (at fair value) and leased it back for 10 years. The payments under the leaseback were fully variable based on the sales volume. ABC determined that the conditions for a sale under IFRS 15 were met.

In its 2019 financial statements, ABC accounted for the transaction as a sale and leaseback. However, because the lease payments varied with sales volume, it measured the lease liability and the right-of-use asset at zero under paragraph 27(b) of IFRS 16. Consequently, ABC recognised the full gain on the sale as the difference between the fair value and the carrying amount of the retail store.

In its 2020 financial statements, ABC amended its accounting for the transaction to reflect the additional insights provided by the explanatory material included in the Committee's November 2020 agenda decision. Applying this retrospectively, ABC measured the right-of-use asset as a proportion of its previous carrying amount, reduced the gain on the sale leg to reflect the rights transferred to the buyer-lessor and recognised an 'other liability'. ABC began to amortise this liability in profit or loss on a straight-line basis over the term of the leaseback.

Under the amendments, ABC will reassess this sale-and-leaseback transaction retrospectively from February 2019. ABC will not necessarily adjust the initial carrying amount of the lease liability recognised when it amended its accounting for the transaction to reflect the Committee's November 2020 agenda decision. However, it reviews its subsequent accounting to ensure that it has not recognised in profit or loss any amount of the gain or loss relating to the right of use retained when remeasuring the lease liability.

Example 20 – Sale and leaseback entered into under IAS 17

IFRS 16.C16–18

In 2015, Company XYZ sells a wind farm and leases it back for 15 years. The payments under the leaseback are fully variable and depend on the quantity of electricity generated by the wind farm. XYZ has the right to repurchase the wind farm after 10 years. It accounts for the transaction as a sale and operating leaseback under IAS 17 and recognises a gain on the date of disposal.

XYZ notes that if it had entered into the transaction after the date of initial application of IFRS 16, it would be required to assess whether the transfer of the asset met the conditions to be a sale under IFRS 15. XYZ notes that the transaction would fail this test because it has a repurchase option – i.e. it would be a failed sale. If it had entered into the transaction after the date of initial application of IFRS 16, XYZ would have applied IFRS 9.

However, when XYZ first applied IFRS 16 in 2019, in accordance with the general transition requirements in IFRS 16, it did not reassess whether the transaction was a sale and leaseback. Instead, it applied the transition requirements in IFRS 16 to the leaseback. XYZ measures the right-of-use asset and lease liability at zero because the lease payments depend on sales or usage, and it need not make any further accounting adjustment on applying the amendments.

Which transactions will a seller-lessee need to reassess?

For many seller-lessees, the amendments will affect only those sale-and-leaseback transactions that include variable lease payments and that have occurred since 2019.

A seller-lessee is required to reassess sale-and-leaseback transactions it entered into after the initial application of IFRS 16. The amendment applies to all sale-and-leaseback transactions occurring after the initial application of IFRS 16 (1 January 2019 for many seller-lessees). However, it is expected to affect only those that include variable lease payments.

Is it necessary to restate sale-and-leaseback transactions entered into under IAS 17?

No. The amendments will apply retrospectively under IAS 8 to sale-and-leaseback transactions entered into after the date of initial application of IFRS 16.

In our view, the amendments will have no practical impact on sale-and-leasebacks entered into under IAS 17. This is because the transition guidance for the amendments needs to be read in conjunction with the original transition guidance for sale-and-leasebacks in paragraphs C16 to C18 in IFRS 16. Under the original transition requirements for sale-and-leasebacks (paragraph C13 of IFRS 16), a seller-lessee:

- does not reassess whether an existing sale-and-leaseback qualifies for sale-and-leaseback accounting on transition; and
- does not apply the partial gain recognition approach to sale-and-leaseback transactions entered into before the date of initial application.

If a seller-lessee did not apply paragraph 100 of IFRS 16 – or restate the gain on sale – for its sale-and-leaseback transactions before initial application of IFRS 16, then in our view the amendments do not apply to these transactions.

Appendix I: IFRS 16 at a glance

Topic	Key facts
Lease definition	• New lease definition with an increased focus on control over the use of the underlying asset
Lessee accounting model	• Single lease accounting model • No lease classification test • Most leases on-balance sheet: - lessee recognises a right-of-use asset and lease liability - treated as the purchase of an asset on a financed basis
Lessor accounting model	• Dual lease accounting model for lessors • Lease classification test based on IAS 17 *Leases* classification criteria • Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset • Operating lease accounting model based on IAS 17 operating lease accounting
Practical expedients and targeted relief	• Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under IFRS 16 is 12 months or less and that do not contain a purchase option • Portfolio-level accounting permitted for leases with similar characteristics if the effect on the financial statements does not differ materially from applying the requirements to individual leases • Optional lessee exemption for leases of low-value items – e.g. underlying assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate
Effective date	• Accounting periods beginning on or after 1 January 2019 • Early adoption is permitted if IFRS 15 *Revenue from Contracts with Customers* is also adopted • Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited). This edition considers the requirements of IFRS 16 *Leases* published by the IASB in January 2016 and amended in September 2022.

The text of this publication refers to IFRS 16 and to selected other current standards in issue at 1 January 2023. Further analysis and interpretation will be needed for a company to consider the impact of IFRS 16 in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change. Accordingly, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

Acknowledgements

We would like to acknowledge the efforts of the following members of the KPMG International Standards Group, who were the principal authors of this publication: Divya Gaur, Ed Haygarth, Madison (Gahyun) Ji and Brian O'Donovan.

We would also like to thank the members of the KPMG global IFRS leases topic team for their contribution:

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Frank Richter	Switzerland
Marcio Rost	Brazil
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