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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2007, London**

Project: **IAS 17 *Leases* – Sale and Leaseback Transactions (Agenda Paper 14(i))**

Introduction

1. During the course of developing its interpretation on Service Concession Arrangements, the IFRIC reached the conclusion that a transaction that took the form of a sale and leaseback should not be accounted for as such if it incorporated a repurchase agreement. The reason was that the seller/lessee would retain effective control of the asset by virtue of the repurchase agreement. Hence the criteria for recognising a sale in paragraph 14 of IAS 18 *Revenue* would not be met.

2. This conclusion was included in the basis for conclusions of D12 *Service Concession Arrangements – Determining the Accounting Model*. However, at its May 2006 meeting the IFRIC decided that this conclusion would apply more widely than to service concession arrangements and that the matter should be the subject of a separate project.

3. This paper addresses two issues:

- *Issue 1* – Must the criteria for recognising a sale in paragraph 14 of IAS 18 be met before an entity accounts for a transaction as a sale and leaseback under IAS 17?
- *Issue 2* – Should transactions incorporating repurchase agreements be accounted for as sale and leaseback transactions under IAS 17?

4. Appendix 1 illustrates the implications of applying the IAS 18 sale recognition criteria to sale and leaseback transactions.

Staff recommendation

5. The staff believe that the standards are clear with respect to Issue 1. It is not necessary to demonstrate that the sales criteria in IAS 18 paragraph 14 have been met before a transaction is treated as a sale and leaseback transaction.

6. The staff believe that the standards are also clear with respect to the second issue:

- Where a sale and leaseback transaction includes a repurchase agreement or a repurchase option whose exercise is almost certain, the seller/lessee should consider whether the arrangement conveys a right of use. If, applying the criteria in SIC 27, it is determined that the arrangement does not convey a right of use, the transaction is outside the scope of IAS 17 and the sale and leaseback accounting in IAS 17 should not be applied;
- If however the sale and leaseback transaction includes a genuine option (that is, an option whose exercise is not almost certain), the transaction is within the scope of IAS 17 and should be accounted for as a sale and leaseback transaction.

7. The staff are not aware of different interpretations arising in practice. In addition, as the standards are clear on both issues, we do not expect significant divergent interpretations to emerge.

8. Consequently, the staff recommend that the IFRIC should not take these issues on to its agenda. Draft wording for IFRIC Update is included in appendix 3.

Description of issues

9. Paragraphs 58 to 66 of IAS 17 *Leases* provide guidance on how to account for sale and leaseback transactions. In particular:

- Where the sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount is not immediately recognised as income by the seller-lessee. Instead it is deferred and amortised over the lease term; and
- Where the sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss is recognised immediately.

10. IAS 18 paragraph 14 sets out the criteria for recognising revenue in respect of a sale of goods:

Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:

a. the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
b. the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
c. the amount of revenue can be measured reliably;
d. it is probable that the economic benefits associated with the transaction will flow to the entity; and
e. the costs incurred or to be incurred in respect of the transaction can be measured reliably.

11. This paper first considers whether the conditions for recognition of a sale in paragraph 14 of IAS 18 must be met before a transaction can be accounted for as a sale and leaseback transaction under IAS 17 (*Issue 1*).

12. The second section of this paper considers whether transactions incorporating repurchase agreements should be accounted for as sale and leaseback transactions under IAS 17 (*Issue 2*).

Issue 1 – Does paragraph 14 of IAS 18 apply to sale and leaseback transactions in general?

13. Paragraph 7 of IAS 8 states that: *"When a Standard or an Interpretation specifically applies to a transaction, other event or condition, the*

accounting policy or policies applied to that item shall be determined by applying the Standard or Interpretation and considering any relevant implementation guidance issued by the IASB for the Standard or Interpretation."

14. Supporters of the view that an entity must first determine whether the transaction meets the conditions for sale in paragraph 14 of IAS 18 before it is accounted for as a sale and leaseback transaction, argue that the first step in a sale and leaseback transaction is a sale of goods. IAS 18 contains specific guidance for when revenue can be recognised in respect of a sale of goods. Therefore, the conditions in paragraph 14 of IAS 18 must be met before the requirements of IAS 17 are applied to the transaction.

15. However, an alternative view is that the most specific standard for sale and leaseback transactions is IAS 17.

16. This alternative view appears to be supported by guidance in IAS 16 on the derecognition of property plant and equipment. In particular, paragraph 69 of IAS 16 states: *"In determining the date of disposal of an item, an entity applies the criteria in IAS 18* Revenue *for recognising revenue from the sale of goods. IAS 17 applies to disposal by sale and leaseback."*

17. It is also interesting to examine the consequences of applying the sale recognition criteria in IAS 18 to common sale and leaseback transactions.

18. Paragraph 14(a) of IAS 18 states that a sale should only be recognised if the seller has transferred all significant risks and rewards of the asset to the buyer.

19. In a sale and finance leaseback, the seller/lessee retains substantially all the risks and rewards of ownership. However, paragraph 59 of IAS 17 implies that a sale should still be recognised but that the excess of the sales proceeds over the carrying amount of the asset should be deferred and amortised over the lease term (see example 2 in appendix 1). The staff note that if IAS 18 applies to sale and leaseback transactions, the guidance in paragraph 59 of IAS 17 (which appears to conflict with the requirements of IAS 18) would not be needed as all sale and finance leaseback transactions fail to meet the conditions in paragraph 14(a) of IAS 18 for recognition of a sale.

20. Secondly, and more fundamentally, paragraph 14(a) requires the seller to have transferred all significant risks and rewards of ownership to the buyer. This means that a seller/lessee can retain only insignificant risks of ownership of the leased asset if the transaction is to qualify as a sale. Unless, the leaseback is for a very short period of time, it is difficult to argue that the risks and rewards retained by the lessee are insignificant (the seller/lessee has the right to use the leased asset over the lease term). Consequently, very few sale and operating leaseback transactions will meet this requirement (mainly very short operating leases). The staff note, that if this view were accepted, leases which clearly meet the definition of an operating lease would be accounted for as a financing.

21. The interaction of IAS 18 and IAS 17 is illustrated in appendix 2.

22. Based on the above analysis, the staff believe that it is clear that IAS 17 sets out the required accounting for sale and leaseback transactions. It is not necessary to apply the requirements of IAS 18 to these transactions.

Issue 2 – Should transactions incorporating repurchase agreements be accounted for as sale and leaseback transactions?

23. Even if it is accepted that in general the sales recognition criteria in IAS 18 do not apply to sale and leaseback transactions in general, it can still be argued that it is inappropriate to apply the sale and leaseback accounting in IAS 17 when the sale and leaseback transaction includes a repurchase agreement.

24. During the development of the service concessions proposals, the service concessions staff proposed that the better standard to apply was IAS 18. They noted that applying the guidance in IAS 17 would lead to the derecognition of an asset over which the seller/lessee retained control. They argued that this approach was inappropriate for three reasons:

- An asset which is the subject of a sale and leaseback transaction with a repurchase agreement meets the definition of an asset of the seller/lessee. Assets are defined by the *Framework* as a resource controlled by the entity as a result of a past event and from which future economic benefits are expected to flow to an entity. A repurchase agreement in a sale and leaseback transaction, gives the seller/lessee control over the asset (the resource), as a result of a past event (the leaseback) and economic benefits are expected to flow to the seller/lessee (future use of the asset);

- An anomalous result is obtained if the IAS 17 rules are applied to sale and leasebacks with repurchase agreements. In a normal sales transaction (i.e. one which does not involve a leaseback), if the seller retains effective control over the leased asset, no sale is recognised. However, if an entity sells an asset as part of a sale and leaseback transaction a sale <u>is</u> recognised despite the fact that the seller/lessee has greater involvement in the leased asset than under a normal sale with repurchase agreement. That is, the seller/lessee has the right of use of the leased asset whilst in a straight sale with a repurchase option, it does not;
- US GAAP prohibits sale and leaseback treatment for sale and leasebacks that incorporate repurchase agreements.

25. However, the staff note that IAS 17 is based upon an analysis of risks and rewards it does not consider control as a criterion for asset recognition/derecognition. It is possible under IAS 17 for an entity to control an asset but not recognise it. For example, a lessee in a normal operating lease may control the asset due to the existence of a purchase option but it does not recognise that asset on balance sheet (equally, under a finance lease, a lessee may not control an asset but will recognise it as an asset).

26. The staff believe that the fact that the seller/lessee has retained control of the leased asset does not necessarily mean that the arrangement should not be accounted for as a sale and leaseback transaction under IAS 17.

27. However, it is important to draw a distinction between sale and leaseback transactions that include repurchase <u>agreements</u> and transactions that include repurchase <u>options</u>. Under a repurchase <u>agreement</u>, there is little doubt that the seller/lessee will reacquire the leased asset at the end of the lease term. Consequently, it can be argued that, although the transaction has the legal form of a sale and leaseback there has been no sale and no

leaseback. The seller/lessee has the right to use the asset for the whole of its life before the sale and leaseback transaction and retains that right after the transaction.

28. This conclusion is consistent with the guidance in SIC 27 – *Evaluating the substance of transactions involving the legal form of a lease.* SIC 27 concludes that where it is almost certain that a seller lessee will reacquire the asset that is the subject of the sale and leaseback transaction, the arrangement may not, in substance, involve a lease. Paragraph 5 of SIC 27 states:

> *IAS 17 applies when the substance of an arrangement includes the conveyance of a right to use an asset for an agreed period of time. Indicators that individually demonstrate that an arrangement may not, in substance involve a lease under IAS 17 include:*
>
> *…(c) an option is included on terms that make its exercise almost certain (e.g. a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable).*

29. Consequently, the staff believe that where a sale and leaseback transaction includes a repurchase agreement or a repurchase option that is almost certain to be exercised, no right of use is conveyed by the leaseback to the seller/lessee. This is because the seller never parts with its right of use. Therefore, the transaction is outside the scope of IAS 17.

30. However, where a sale and leaseback transaction includes a repurchase option and the exercise of that option by the lessee is not “almost certain”. The staff believe that the arrangement includes a lease. Therefore, it can, reasonably, be argued that the most specific guidance for transactions of this type is IAS 17.

31. This approach to sale and leaseback transactions appears to be supported by current practice. The staff understand that it is common practice in many jurisdictions for sale and leaseback transactions to include repurchase options. However, as long as the lease qualifies as an operating lease, they are not currently accounted for as financings.

Staff conclusions and recommendations

32. The staff believe that the standards are clear with respect to Issue 1. It is not necessary to demonstrate that the sales criteria in IAS 18 paragraph 14 have been met before a transaction is treated as a sale and leaseback transaction.

33. The staff believe that the standards are also clear with respect to the second issue:

- Where a sale and leaseback transaction includes a repurchase agreement or a repurchase option whose exercise is almost certain, the seller/lessee should consider whether the arrangement conveys a right of use. If, applying the criteria in SIC 27, it is determined that the arrangement does not convey a right of use, the transaction is outside the scope of IAS 17 and the sale and leaseback accounting in IAS 17 should not be applied;
- If, however, the sale and leaseback transaction includes a genuine option (that is, an option whose exercise is not almost certain), the transaction is within the scope of IAS 17 and should be accounted for as a sale and leaseback transaction.

34. In deciding whether to take an issue on to its agenda, the IFRIC must consider its agenda criteria. To be added to the agenda, an issue should:

(a) Have practical and widespread relevance;

(b) Involve significant divergent interpretations (either emerging or already existing in practice)

(c) Be likely to result in a consensus view of the IFRIC on a timely basis;

(d) Be unrelated to a Board project that is expected to be completed in the near future.

35. The staff understand that significant divergent interpretations do not exist in practice. In addition, as the staff believe that the standards are clear on both issues, we do not expect significant divergent interpretations to emerge.

36. Finally, the staff note that the Board has recently added a leasing project to its agenda. The staff question whether it is appropriate to make a significant change to current accounting practice when a more fundamental revision of the standard is being considered.

37. Consequently the staff recommend that the IFRIC should not take these issues on to its agenda. Draft wording for IFRIC Update is included in appendix 3.

Does the IFRIC agree that:

- **It is not necessary to demonstrate that the sales criteria in IAS 18 paragraph 14 have been met before a transaction is treated as a sale and leaseback transaction (Issue 1)?**
- **Where a sale and leaseback transaction includes a repurchase agreement or a repurchase option whose exercise is almost certain, the seller/lessee should consider whether the arrangement conveys a right of use. If, applying the criteria in SIC 27, it is determined that the arrangement does not convey a right of use, the transaction is outside the scope of IAS 17 and the sale and leaseback accounting in IAS 17 should not be applied;**
- **If a sale and leaseback transaction includes a genuine repurchase option (that is, an option whose exercise is not almost certain), the transaction is within the scope of IAS 17 and should be accounted for as a sale and leaseback transaction.**
- **Does the IFRIC agree with the staff's recommendation not to take these issues on to IFRIC's agenda?**

Impact for the Service Concessions project

38. The staff note that the Service Concessions Interpretation (IFRIC 12) relies on the conclusion that the sale and leaseback accounting requirements of IAS 17 do not apply to service concession arrangements in which pre-existing infrastructure is transferred to the operator for the duration of the concession and is returned to the grantor at the end[1] of the concession period.

39. The staff believe that the recommendations in this paper do not undermine the conclusions in the IFRIC 12. In many situations, covered by IFRIC 12,

[1] There is no similar issue for infrastructure that is constructed as part of the service concession arrangement as the operator does not obtain a right of use of the infrastructure.

the mechanism by which the Grantor regains ownership of the infrastructure at the end of the concession agreement will be a repurchase agreement (or a repurchase option whose exercise is almost certain). Consequently, the arrangement may not convey a right of use.

40. There may be situations where the repurchase option is a genuine option. Where this is the case, it could be argued that the leaseback of the infrastructure creates a right of use for the grantor. However, the final version of IFRIC 12 amends IFRIC 4 – *Determining whether an arrangement contains a lease* to exclude contracts that are within the scope of IFRIC 12 from the scope of IFRIC 4. Consequently, although these arrangements may contain a lease, they should be accounted for in accordance with IFRIC 12 rather than IAS 17.

Appendices 1 – 3 [*omitted from observer notes*]