Project **Leases**

Topic **Sale and Leaseback Transactions**

Purpose

1. The purpose of this paper is to obtain preliminary views from the boards on how a seller/lessee should account for a sale and leaseback transaction under a right of use accounting model. This paper also briefly discusses how the buyer/lessor should account for sale and leaseback transactions. However, we will not ask the boards to reach preliminary views on lessor accounting at this stage.

2. The staff think that accounting for sale and leaseback transactions is essentially a question of asset derecognition - that is, when is it appropriate for the seller/lessee to derecognise part or all of the asset that is the subject of the transaction? We note that neither board has developed comprehensive guidance on when to derecognise a non-financial asset (although guidance in particular situations does exist). This paper analyses a number of different derecognition approaches. However, we are not attempting to develop a general theory of derecognition for non-financial assets. That is outside the scope of this project.

Background

3. In a sale and leaseback transaction, the seller/lessee sells an asset it owns to a buyer/lessor and then leases back that same asset. Such transactions may be entered into to generate cash flow, to reduce the risks associated with owning the asset or to obtain off balance sheet financing.

This paper has been prepared by the technical staff of the FAF and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

4. Existing accounting for sale and leaseback transactions depends on the classification of the leaseback. If the lessee classifies the leaseback as an operating lease and other specified conditions are met, any gain or loss on sale is recognised immediately. If the leaseback is classified as a finance lease, the lessee defers and amortises any gain on sale over the lease term.

5. US GAAP has additional requirements for sale and leaseback transactions involving real estate. FASB Statement No. 98 *Accounting for Leases* describes specific forms of continuing involvement that do not allow a seller/lessee to qualify for sale and leaseback accounting.

6. Throughout this paper we have assumed that the sale proceeds received by the seller/lessee equal the fair value of the property sold and that the leaseback is at a market rate. In practice, the seller/lessee may be willing to pay higher than market rentals in return for increased proceeds from the sale of the asset. Similarly, the seller/lessee may be willing to accept a lower sales price for the asset if the future rentals are below market rates. The staff propose to include guidance in any final standard to ensure that the carrying amount of the right-of-use asset and any profit or loss on sale are neither overstated nor understated. This could be achieved by requiring the seller/lessee to adjust the carrying amount of the right-of-use asset to reflect market rentals.

7. In developing this paper, the staff have referred to the IASB's exposure draft (ED) on derecognition of financial instruments. Non-financial assets are outside the scope of that document. However, the staff think that the principles set out in that ED may be useful in developing an approach to sale and leaseback transactions.

Structure of the paper

8. This paper is split into four sections:

   (a) The first section of the paper attempts to identify the asset that should be considered for derecognition. The staff have identified two possible approaches. Under the first approach, the entire physical asset is assessed for derecognition. Under the second approach, only that part of the asset that is transferred to the lessor is considered for derecognition (a partial derecognition approach). We recommend that the boards adopt the first of these approaches.

   (b) The second section of this paper discusses the need to develop criteria for determining when the seller/lessee should derecognise an asset. The IASB staff recommend that the boards develop criteria for determining when a seller/lessee should derecognise an asset. The FASB staff do not think it is necessary to develop any such criteria.

   (c) The third section of this paper examines what form any criteria should take. We discuss both a risk and rewards based approach and a control based approach to derecognition and recommend that the boards adopt a control based approach.

   (d) The final section of this paper briefly discusses how the buyer/lessor should account for sale and leaseback transactions.

9. The appendix to this paper describes a partial derecognition approach to sale and leaseback transactions.

Identifying the asset

10. We have identified two possible approaches to determining the asset to be derecognised in a sale and leaseback transaction

11. Under the first approach the seller/lessee evaluates whether the entire asset qualifies for derecognition (an entire asset approach). For example, in the sale

and leaseback of an office building the seller/lessee would apply the derecognition tests to the office building. If the building qualifies for derecognition, the seller/lessee would derecognise the office building and recognise in its place a right-of-use asset and an obligation to pay rentals in respect of the leaseback. This approach is illustrated in example 1.

Example 1

Entity A owns an office building which has a carrying amount of CU700 and a fair value of CU1000. The remaining useful life of the building is 20 years. Entity A agrees to sell the building to entity B for CU1000. At the same time, entity A agrees to lease the building back from entity B for 5 years. Annual rentals on the leaseback are CU85. Entity A's incremental borrowing rate is 10%.

At the start of the leaseback the present value of the lease payments discounted at entity A's incremental borrowing rate is CU322

The following table illustrates the relevant portions of entity A's statement of financial position and profit or loss.

Statement of financial position

			Year				
	0	**0**	**1**	**2**	**3**	**4**	**5**
	Pre-sale	**Post-sale**					
Property	700	0	0	0	0	0	0
Cash	0	1000	915	830	745	660	575
Right-of-use asset	0	322	258	193	129	64	0
Obligation to pay rentals	0	-322	-269	-211	-148	-77	0
Net assets	700	1000	904	812	726	647	575

Profit or loss

			Year			
	1	**2**	**3**	**4**	**5**	**Total**
Gain	300	0	0	0	0	300
Amortisation	-64	-64	-64	-64	-64	-322
Interest	-32	-27	-21	-15	-8	-103
	203	-91	-86	-79	-72	-125

12. Under the second approach, the seller/lessee considers only the bundle of rights and obligations that are transferred to the buyer/lessor for derecognition (a partial derecognition approach). Those rights retained under the leaseback would not be derecognised. For example, in a sale and leaseback of an office building,

the seller/lessee would continue to recognise a portion of the building representing its right to use the building during the leaseback and derecognise that portion of the building relating to the rights transferred to the buyer/lessor (for example, ownership rights, the right to use the building after the end of the leaseback, rights to change or develop the property). Example 2 illustrates this approach.

Example 2

The facts are the same as in example 1.

Entity A calculates the amount of the building to be derecognised (CU475) based upon the relative fair values of the rights retained (ie the right-to-use the property during the leaseback CU322) and the rights transferred (ie all other rights CU678). The gain on sale is calculated as follows:

Proceeds (CU1000) – Obligation assumed (CU322) – Carrying amount of building derecognised (CU475) = CU203

Statement of financial position

	Year						
	0 Pre-sale	**0 Post-sale**	**1**	**2**	**3**	**4**	**5**
Property	700	225	180	135	90	45	0
Cash	0	1000	915	830	745	660	575
Right-of-use asset	0	0	0	0	0	0	0
Obligation to pay rentals	0	-322	-269	-211	-148	-77	0
	700	903	826	754	687	628	575

Profit or loss

	Year					
	1	**2**	**3**	**4**	**5**	**Total**
Gain	203	0	0	0	0	203
Amortisation	-45	-45	-45	-45	-45	-225
Interest	-32	-27	-21	-15	-8	-103
	126	-72	-66	-60	-53	-125

13. In March 2009, the IASB published an exposure draft that sets out a proposed derecognition model for financial instruments. This ED discusses how to identify the asset that is to be considered for derecognition. The derecognition requirements proposed in the ED are applied to a part of a financial asset only if

that part comprises specifically identified cash flows or a proportionate share of the cash flows from that asset. If this is not the case the derecognition requirements are applied to the asset in its entirety

14. Non-financial assets do not directly create cash flows in the same way as financial assets. However, they can be used to generate cash flows through use in the business or sale. The non-financial asset underlying a lease could be viewed as a bundle of rights that can be identified and transferred separately. For example, it could be argued that the right to use an office building for 5 years represents specifically identified rights. In a sale and leaseback transaction the right to use the asset during the leaseback is retained so it would not be considered for derecognition under the proposals. However, the other rights associated with the office building (eg the right to sell the building, the right to use it after the end of the leaseback) are transferred in the transaction. Consequently, the part of the building representing these transferred rights would be considered for derecognition.

15. However, some do not think it is possible to divide up the rights embodied in a non-financial asset in the way that you can divide up the cash flows of a financial asset. Consequently, they would only ever consider the entire asset for derecognition.

16. The staff note that the question of which asset to apply the derecognition tests to is similar to the questions raised when examining the accounting model for lessors. The approach to lessor accounting depends upon identifying what is transferred to the lessee in a lease contract. Can the underlying leased item be divided up into a parcel of rights and obligations that can be transferred separately or is the underlying leased asset indivisible? Those who support a partial derecognition approach to lessor accounting should logically support a partial derecognition approach to sale and leaseback transactions. Those who think the lessor should retain the underlying asset in its statement of financial position should support an entire asset approach.

17. The staff note that at their meetings in May, the boards tentatively decided not to adopt a partial derecognition approach to lessor accounting. We think that the

boards' approach to sale and leaseback transactions should be consistent with that decision. In addition we note that an entire asset approach to derecognition is simpler to apply than a partial derecognition approach. Consequently, we recommend that the seller/lessee should consider whether the entire asset qualifies for derecognition.

Question 1
The staff recommend that a seller/lessee should consider whether the entire asset qualifies for derecognition. Do the boards agree with the staff's recommendation?

18. Having decided to which asset to apply the derecognition tests, the boards must now decide when that asset should be derecognised. The following section discusses how derecognition tests could be applied to the entire asset. The appendix to this paper describes how these tests could be applied under a partial derecognition approach.

When should the asset be derecognised? - Entire asset approach

19. In a sale and leaseback transaction, the seller/lessee always has continuing involvement in the asset because of the existence of the leaseback. Some would argue that the existence of this continuing involvement should always prevent derecognition of the leased item. However, this may not be appropriate for all leasebacks. For example, an entity could sell an office building with a life of 20 years and lease it back for one year. If the seller/lessee was prohibited from derecognising the building, it would recognise a liability for the whole of the sales proceeds. This liability is clearly overstated and may not meet the definition of a liability. Consequently, the staff do not support an approach that would never result in a seller/lessee derecognising the leased asset.

20. Conversely, the boards could adopt an approach whereby the leased asset is always derecognised and the rights and obligations arising in the leaseback are recognised. The staff note that unlike under the existing lease accounting standards, the seller/lessee will always recognise a liability for the obligation to

pay rentals under the leaseback (see example 1). Consequently, sale and leaseback transactions will no longer give rise to off-balance sheet financing. We also note that this approach to derecognition would be consistent with the alternative approach to derecognition of financial instruments described in the IASB's derecognition exposure draft.

21. Always derecognising the leased item in a sale and leaseback transaction has a number of advantages:

    (a) It results in consistent accounting treatment for assets and liabilities arising from normal leasing transactions and for assets and liabilities that arise from sale and leaseback transactions (history will not matter).

    (b) It is simpler to apply than an approach that requires the seller/lessee to differentiate between transactions that qualify for derecognition and those that do not.

22. However, there are a number of disadvantages to this approach:

    (a) Always derecognising the leased item in a sale and leaseback transaction could lead to the seller/lessee recognising a gain on a transaction that is economically a financing for example a sale followed by a leaseback for substantially all the remaining life of the asset. It may be possible to avoid this problem by deferring any gain in transactions that are economically financings. However, the staff note any deferred gain that is recognised would not meet the definition of a liability.

    (b) Many existing standards use criteria (eg control or risks and rewards) to differentiate between transactions that qualify for derecognition and those transactions that do not. Consequently, always derecognising the leased item would be inconsistent with those standards.

    (c) It is inconsistent with the proposals in the IASB's derecognition ED which uses control based criteria to determine when a transaction qualifies for derecognition.

23. The FASB staff recommend that the boards adopt an approach whereby the leased asset is always derecognised and the rights and obligations arising in the leaseback are recognised. Any gains or losses arising in such a transaction should be recognised immediately (ie no deferral of gains). The FASB think that this approach is more consistent with the boards' conceptual frameworks.

24. However, for the reasons set out in paragraph 22, the IASB staff recommend that the boards develop criteria to differentiate between transactions that qualify for derecognition and those that do not.

Question 2
Which of the two approaches to derecognition in a sale and leaseback transaction do the boards support: (a) always derecognising the leased asset; or (b) developing criteria to differentiate between transactions that qualify for derecognition and those that do not?

Question 3
If the boards support approach (a) - that is, to always derecognise the leased item - the staff think that any gain or loss on the transaction should be recognised immediately. Do you agree?

25. The rest of this paper discusses the criteria that could be used to differentiate between transactions that qualify for derecognition and those that do not and is only relevant if the boards support developing such criteria.

Derecognition criteria

26. The staff have examined two different approaches to determining when a seller/lessee should derecognise a leased asset in a sale and leaseback transaction: a risk and rewards based approach; and a control based approach.

Risk and rewards approach

27. The boards could decide to require derecognition of the leased item when the sale and leaseback transaction transfers significant risks and rewards associated

with the leased item to the lessor. The threshold for derecognition could be when the transaction transfers substantially all the risks and rewards or when the transaction transfers a majority of the risks and rewards.

28. A risk and rewards based approach would be consistent with the approach to derecognition in some existing standards (for example the existing lease accounting standards and IAS 18 Revenue).

29. However, the staff note that this approach could lead to the seller/lessee recognising (or continuing to recognise) assets and liabilities that do not meet the framework definition of assets or liabilities. Consider the following example:

> Example 3
>
> Entity A agrees to sell a building with a remaining useful life of 20 years to entity B and lease it back for a period of 5 years. Entity A agrees at the end of the lease to compensate entity B for any fall in value of the building below CU2000 (its expected market value at the end of the lease). Entity B agrees to compensate entity A if the value of the building exceeds CU2000 at the end of the lease.

30. In this example, entity A has retained the right to use the building for the next 5 years and is exposed to the risks and rewards associated with increases and decreases in the value of the property over that period. Consequently, it can be argued that entity B has retained substantially all the risks and rewards of ownership of the building. However, if the building were not derecognised, the lessee would continue to recognise an asset to which it has no rights beyond the end of the lease term and would recognise a liability for the full sales proceeds which may be significantly greater than the obligation it has assumed under the leaseback.

31. In addition, risk and rewards based derecognition tests can be complex to apply. Existing standards that use risk and rewards based tests have required significant application guidance (for example, the existing lease accounting standards, IAS 39 and parts of the existing consolidation standards).

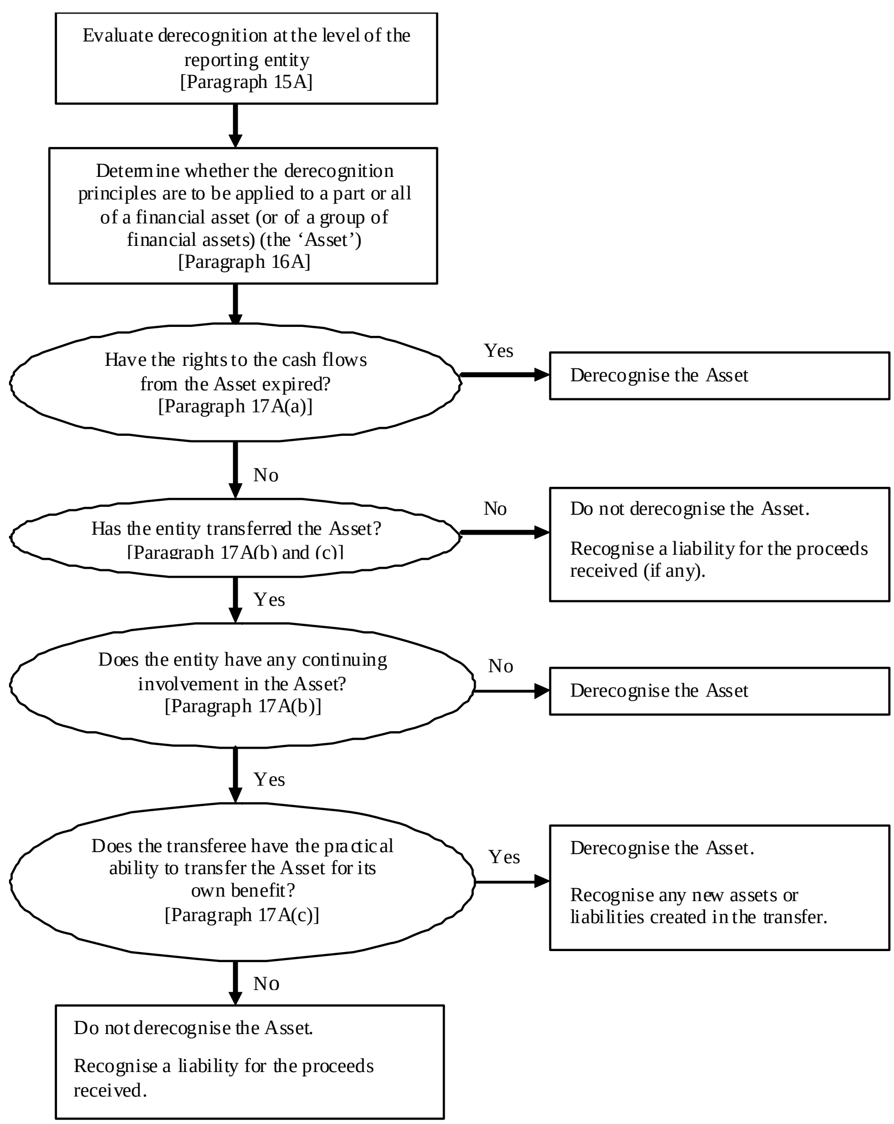
32. The staff also note that a risks and rewards based approach to derecognition is inconsistent with the controls based approach used in the IASB's derecognition exposure draft.

Control model

33. Under a control based derecognition model, the seller/lessee would derecognise the leased item only when it loses control of the leased item. For example, in a sale and leaseback of an office building the seller/lessee would derecognise the office building when it loses control of that building.

34. The exposure draft on derecognition proposes a control based approach to derecognition of financial assets. As set out in the exposure draft, the IASB adopted a control based approach to derecognition as it thinks such an approach is consistent with the Framework definitions of assets and liabilities.

35. The derecognition approach proposed in the ED is summarised in the following flow chart:



36. This approach can, with some modification, be applied to non-financial assets. In this case, the asset to which the derecognition tests are applied is the entire asset (box 2). Applying this approach to the entire asset:

    (a) The seller/lessee's rights over the entire asset have not expired – they have retained some rights (box 3).

    (b) The seller/lessee has transferred the asset to the buyer/lessor through the sale (box 4).

    (c) The seller/lessee has continuing involvement in the asset through the leaseback (box 5).

37. Consequently, in order to derecognise the asset the seller/lessee must determine whether the buyer/lessor has the practical ability to transfer the asset for its own benefit (box 6).

38. It can be argued that the existence of the leaseback would always preclude derecognition as even if the buyer/lessor is permitted to sell the asset it will in general have to impose conditions on that sale – that is, it will have to sell the asset with the leaseback in place[1]. As discussed above, the staff think that in some situations not derecognising an asset in a sale and leaseback transaction would be inappropriate. Consequently, the staff suggest that in a sale and leaseback transaction the fact that the buyer/lessor can only sell the asset with the lease attached should be ignored for the purposes of determining whether the buyer/lessor has the practical ability to sell the leased item. The staff also recommend that the existence of options to terminate or extend the leaseback should also be ignored. Options of this type may affect the amount that the buyer/lessor could sell the property for but should not affect their ability to sell the property.

[1] Although in many cases the existence of the leaseback may make the property more attractive to potential buyers rather than less attractive.

Question 4
The staff thinks that in a sale and leaseback transaction the fact that the buyer/lessor can only sell the asset with the lease attached (including any option to extend or terminate the lease) should be ignored for the purposes of determining whether the buyer/lessor has the practical ability to sell the leased item. Do the boards agree?

39. If this approach is taken many sale and leaseback transactions will result in the derecognition of the leased asset and recognition of a right-of-use asset and an obligation to pay rentals. This is because in many sale and leaseback transactions the buyer/lessor has the practical ability to sell the asset.

40. However, there may be factors associated with the leaseback that would restrict the buyer/lessor's practical ability to sell the asset. For example, if the seller/lessee has a purchase option the buyer/lessor is unlikely to have the practical ability to sell the asset. Consequently, in those situations, derecognition of the asset would be prohibited.

41. The following table summarises some common clauses in leases and the effect they would have on the buyer/lessor's practical ability to sell.

Lease clause	**Effect on practical ability to sell**
Purchase option	Will restrict practical ability to sell unless underlying asset is fungible
Residual value guarantee	The buyer/lessor could sell the underlying asset and retain its rights under the residual value guarantee. Selling the underlying asset without a residual value guarantee from the seller/lessee may result in a lower selling price but should not affect the buyer/lessor's practical ability to sell.
Buyer/lessor put option	Depending upon the exercise price of the put option, this may restrict the buyer/lessor's practical ability to sell. For example, if the exercise price of the put option is significantly higher than the expected fair value of the asset, the buyer/lessor may be economically compelled to retain the asset and exercise the put.

Staff recommendation[2]

42. The staff recommend that the boards adopt a control based approach to derecognition of assets in a sale and leaseback transaction as it is consistent with the asset and liability definitions in the framework and is likely to be easier for preparers to apply than a risk and rewards based approach.

Question 5
The staff recommend that the boards adopt a control based approach to derecognition of assets in a sale and leaseback transaction. Do the boards agree?

Accounting by the buyer/lessor

43. The staff have assumed that accounting by the buyer/lessor will mirror the accounting by the seller/lessee. That is, if the seller/lessee does not derecognise the asset, the buyer/lessor will not recognise the asset and vice-versa.

44. The accounting by the buyer/lessor can be summarised as follows:

Seller/lessee derecognises	Buyer/lessor recognises the entire asset in its statement of financial position and then records the leaseback.
No derecognition	Buyer/lessor recognises a receivable equal to the sales price paid

[2] This recommendation only applies if in answering question 2, the boards have decided to develop criteria to differentiate between transactions that qualify for derecognition and those transactions that do not.

Appendix – A partial derecognition approach

A1. Under a partial derecognition approach, the seller/lessee has retained the right to use the leased item during the leaseback and transferred all other rights to the buyer/lessor. Rights retained under the leaseback would not be derecognised. For example, in a sale and leaseback of an office building, the seller/lessee would continue to recognise a portion of the building representing its right to use the building during the leaseback and derecognise that portion of the building relating to the rights transferred to the buyer/lessor (in general, ownership rights and the right to use the building after the end of the leaseback). Example 2 (in the main part of this paper) illustrates this approach.

A2. As discussed above the boards could:

(a) require the seller/lessee to always derecognise the transferred portion of the leased asset and recognise any new rights and obligations arising under the leaseback; or

(b) develop criteria to differentiate between transactions that qualify for derecognition and those that do not.

A3. The staff have examined two different ways to differentiate between transactions that qualify for derecognition and those that do not: a risk and rewards based approach; and a control based approach.

A4. Under a risk and rewards based approach, the seller/lessee would:

(a) continue to recognise the whole of the asset if it has retained significant risks and rewards associated with the property after the end of the leaseback. For example, the seller/lessee may provide the buyer/lessor with a residual value guarantee or may have an option to lease the asset for the rest of its expected life.

(b) derecognise that part of the asset representing the rights sold to the buyer/lessor if significant risks and rewards associated with the property after the end of the leaseback have been transferred.

A5. Under a control based approach, the seller/lessee would continue to recognise the whole of the asset only if it has retained control over the asset transferred. In all other situations the seller/lessee would derecognise that portion of the asset transferred to the buyer/lessor and continue to recognise its right to use the asset during the leaseback.

A6. Under a partial derecognition approach, the seller/lessee is considered to have retained the right to use the leased item during the leaseback. Consequently, the seller/lessee may have no continuing involvement in the transferred asset and derecognition may be easier to achieve than under an entire asset approach.

A7. However, the lessee may have continuing involvement in the transferred asset if for example it has an option to extend the lease, a purchase option or has provided a residual value guarantee to the buyer/lessor. If the seller/lessee has continuing involvement in the transferred asset, derecognition can only take place if the buyer/lessor has the practical ability to sell the transferred asset. Unlike under the entire asset approach, the buyer/lessor will not need to impose conditions on any sale (unless the seller/lessee has a purchase option or an option to extend the lease) of the transferred asset as it would not sell the right to use the asset during the term of the leaseback.

A8. Consistent with our recommendations above the staff recommend that, if the boards decide to develop criteria to differentiate between transactions that qualify for derecognition and those that do not, the boards adopt a control based approach.