Project	**Revenue Recognition**
Topic	**Sale and repurchase agreements – put option**

Purpose of this paper

1. This paper provides analysis of the accounting for a sale and repurchase agreement when a customer has the 'unconditional right to require the entity to repurchase the asset (a put option)' (paragraph B48 of the Exposure Draft *Revenue from Contracts with Customers*). This paper seeks the boards' views on whether, in some circumstances, put options in a sale and repurchase agreement should be accounted for as a lease.

2. This paper does not request any changes to the proposal in the exposure draft for sale and repurchase agreements in which an entity has an unconditional obligation to repurchase the asset (a forward) and where an entity has unconditional right to repurchase the asset (a call option). The relevant paragraphs from the exposure draft that outline the accounting for these agreements (and put options) are reproduced in Appendix A.

Staff recommendation

3. The staff recommends that a sale and repurchase agreement with a put option and a repurchase price below the original sales price should be accounted for as a lease. When the repurchase price is at the original sales price, the staff recommends the put option should be accounted for as a sale with a right of return.

Background and feedback

4. The exposure draft acknowledged that 'sometimes an entity sells an asset and also enters into a repurchase agreement' (paragraph B47 of the exposure draft) for the same asset, or an asset that is substantially the same. The exposure draft outlined three main forms of sale and repurchase agreements, one of which was 'a customer's unconditional right to require the entity to repurchase the asset (a put option)' (paragraph B48 of the exposure draft).

5. The exposure draft proposed that put options would be accounted for 'similarly to the sale of a product with a right of return' (paragraph B52 of the exposure draft).

6. Accounting for a put option as a right of return seems to work well when the asset is returned in, or close to, the same condition in which it was sold. In these cases, the repurchase price is often at or near to the original sales price and the refund liability would be measured at the original sales price, adjusted for the entity's expectations that the asset would be returned. Revenue would be recognised on transfer of the asset to the extent that the entity does not expect to refund any consideration to the customer.

7. However, some respondents to the exposure draft have indicated that the repurchase price of a put option is not always at, or near to the original sales price. In some industries, this is because the put option is not exercisable until a reasonable period of time after the original sale (eg 3 or 4 years after the original sale). In these cases, the repurchase price is lower than the original sales price, because the asset will not be returned in the same condition it was sold (ie the asset has been used). Therefore, the customer can be viewed as having a right to use the asset until the put option becomes exercisable, at which point the customer can choose to keep the asset or sell it back to the entity. Some argue that the put option in this case appears economically to be more like a lease with a purchase option, instead of a right of return.

8. Respondents have explained that section 840-10-55 of Topic 840 *Leases* precludes revenue recognition for these put options and requires them to be

accounted for as a lease. Consequently the exposure draft proposal to account for them as a right of return and recognise revenue at the time of transfer represents a change in practice.

Staff analysis

9. In the light of the feedback received, the staff propose the following alternatives for accounting for sale and repurchase agreements when the customer has a right to require the entity to repurchase the asset (a put option):

    (i) *Alternative A*: account for all put options as a sale of the product and a right of return (exposure draft proposal).

    (ii) *Alternative B*: when the repurchase price is below the original sales price, account for the put option as a lease. When the repurchase price is at the original sales price, the put option would be accounted for as a sale with a right of return.

Alternative A

10. Alternative A would account for all put options as a sale with a right of return, regardless of the relationship between the repurchase price and the original sales price. Alternative A would accounts for all put options consistently.

11. When the put option is exercisable at a repurchase price that is less than the original sales price, Alternative A would result in revenue recognition on the transfer of the asset to the customer. In these cases, the revenue recognised would be the difference between the original sales price and the estimate of the refund liability. Since the refund liability will always be lower than the original sales price, even when the facts and circumstances make it virtually certain that the customer would exercise its option, revenue would always be recognised for these put options.

12. The staff observe that there may be structuring opportunities between the lease and revenue standard when it is either virtually certain or unclear that the customer would exercise its option to require the entity to repurchase the asset (ie to ‘return’ the asset). This is because revenue would not be recognised on

transfer of the asset if the contract were instead structured as a lease with a purchase option. In this case, it would be determined that the lessee (or customer) would not have significant economic incentive (March 2011 tentative decision of the boards in the leases project) to exercise the purchase option (ie the lessee would return the asset to the lessor) and the lessor would likely recognise income over the term of the lease (based on the Exposure Draft *Leases)*.

13. However the staff also observe that when it is certain that the customer would exercise its option to require the entity to repurchase the asset (ie the 'lessee' has significant economic incentive to exercise the purchase option), the accounting treatment in leasing and in revenue may be the same. This is because in both cases revenue may be recognised at the time of transfer.

Alternative B

14. Alternative B would require an entity to account for put options as a lease, when the repurchase price is below the original sales price. All other put options would be accounted for as a sale of the product with a right of return.[1]

15. This alternative recognises that when the repurchase price is less than original sales price, the customer does not have a right of return, but rather a right to use the asset for a period of time. In these cases, the customer is paying consideration (which is the difference between the original sales price and the repurchase price) for the right to use the asset. Economically, the repurchase agreement is similar to a lease, instead of a right of return.

16. By requiring entities to apply account for these put options as a lease, this alternative would create consistency in accounting for things that are economically similar. Furthermore, this alternative would eliminate any structuring activities between the lease and revenue standard.

[1] If the repurchase price is greater than the original sales price, the staff thinks the contract is in effect a financing arrangement. However, the staff does not have a separate recommendation for that circumstance because the accounting for the financing would be the similar to accounting for the right of return when it is expected to be exercised, because the entity continues to recognise the asset (or the right to receive the asset) and a refund liability which initially would be measured at the amount of the original sales price because the option is virtually certain to be exercised.

Staff recommendation

17. The staff recommend accounting for sale and repurchase agreements when the customer has an unconditional right to require the entity to repurchase the asset (a put option) in accordance with Alternative B. Therefore, when the repurchase price is below the original sales price, the entity would account for the repurchase agreement with a put option as a lease. All other put options would be accounted for as a sale of the product with a right of return (proposed in the exposure draft).

Question for the boards
Do the boards agree with the staff recommendation? If not, why not?

Appendix A – Excerpt from Exposure Draft *Revenue from Contracts With Customers*

A1. The following paragraphs are reproduced from the exposure draft:

B48 Repurchase agreements come in three main forms:

(a) an entity's unconditional obligation to repurchase the asset (a forward);

(b) an entity's unconditional right to repurchase the asset (a call option); and

(c) a customer's unconditional right to require the entity to repurchase the asset (a put option).

B49 If an entity has an unconditional obligation or unconditional right to repurchase the asset (a forward or a call option), the customer is constrained in its ability to direct the use of, and receive the benefit from, the asset. Hence, the customer does not obtain control of the asset (even though the customer may have physical possession of the asset), and the entity shall account for the sale and repurchase agreement as:

(a) a right of use in accordance with IAS 17, if the entity repurchases the asset for an amount that is less than the original sales price of the asset; or

(b) a financing arrangement, if the entity repurchases the asset for an amount that is equal to or more than the original sales price of the asset.

B51 If the sale and repurchase agreement is a financing arrangement, the entity shall continue to recognise the asset and shall recognise a financial liability for any consideration received from the customer. The entity shall recognise the difference between the amount of consideration received from the customer and the amount of consideration paid to the customer as interest and, if applicable, holding costs (for example, insurance).

B52 If a customer has the unconditional right to require the entity to repurchase the asset (a put option), the customer obtains control of the asset and the entity shall account for the agreement similarly to the sale of a product with a right of return as discussed in paragraphs B5–B12…..