Project **Leases**

Topic **Sale and leaseback transactions: when does a sale and leaseback transaction occur?**

Purpose

1. The purpose of this paper is to discuss when a sale and leaseback transaction should occur.

Proposals in the ED

2. The leases exposure draft (ED) proposed that:

   > 67(a) if the transfer meets the conditions for a sale (…), the transferor will account for the sale in accordance with applicable IFRSs and US GAAP, and for the lease in accordance with [the leases requirements]

3. Otherwise, that contract will be accounted for as financing.

4. The boards noted in paragraph B31 of the ED that sale and leaseback transactions may have conditions that generally do not arise in normal sales contracts. For example, in a real estate transaction a seller/lessee guarantees the buyer/lessor's investment for a return on that investment. The boards noted that such conditions reflect that many sale and leaseback transactions are merely an alternative source of financing and should be accounted as such. Consequently, the boards proposed that the threshold to achieve a sale and then to account for a transaction as a sale and leaseback should be higher than the

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threshold to recognise a sale in accordance with the revenue recognition exposure draft.

5. Consequently, paragraph B32 of the ED proposed the following conditions that would normally preclude the seller/lessee from transferring more than a trivial amount of the risks and benefits associated with the transferred asset at the end of the contract and that therefore do not result in a purchase or sale:

    (a) The seller/lessee has an obligation or an option to repurchase the asset at an amount that is not equal to fair value at the time of repurchase, or the buyer/lessor can compel the seller/lessee to repurchase the asset.

    (b) The seller/lessee guarantees the buyer/lessor's investment or a return on that investment.

    (c) The seller/lessee provides the buyer/lessor with a residual value guarantee.

    (d) The seller/lessee provides non-recourse financing to the buyer/lessor.

    (e) The seller/lessee retains an obligation to service any existing debt related to the asset.

    (f) The seller/lessee provides collateral on behalf of the buyer/lessor (other than the transferred asset) or guarantees the buyer/lessor's debt.

    (g) The seller/lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer/lessor.

    (h) The seller/lessee enters into a sale and leaseback transaction involving asset enhancements without leasing the transferred asset from the buyer/lessor.

    (i) The buyer/lessor is obliged to share a significant portion of the appreciation of the asset with the seller/lessee.

    (j) Any other provisions or circumstances exist that allow the seller/lessee to participate in any future profits of the buyer/lessor or the appreciation of the transferred asset, eg a situation in which the seller/lessee owns or has an option to acquire a significant interest in the buyer/lessor.

6. The proposed conditions were adapted from the continuing involvement principles in Topic 840 *Leases* in the *FASB Accounting Standards Codification*®.(formerly FAS 98) that specifically addressed sale and leaseback transactions for real estate.

7. For US GAAP where the underlying asset is not real estate (eg sale and leaseback of an aircraft) and when applying IFRSs when the underlying asset is any type of asset, real estate or otherwise, there are no additional conditions above those that exist in 'normal' sale accounting guidance for determining whether the transaction involving a potential leaseback qualifies as a 'sale'.

Feedback received

8. Some respondents agreed with the boards' proposed criteria for determining how to account for a sale and leaseback transaction.

> [X] concurs with the criteria for classification of sale and leaseback transactions. The treatment is considered an appropriate reflection of the intention of the transaction, thus providing transparency to the users of the financial statements. [CL463]

9. However, a majority of the respondents disagreed with the proposal to include additional conditions beyond those that exist in other guidance on 'sale' accounting when determining whether an entity should recognise a sale of an asset when it is combined with a leaseback of the same asset. These respondents:

   (a) questioned why the ED proposed a higher threshold for recognising a transaction as a sale in a sale and leaseback transaction than the threshold in the revenue recognition ED:

   > The proposal also includes several provisions in paragraph B31 similar to the continuing involvement provisions in existing U.S. GAAP even though continuing involvement is no longer a factor in recognizing sales of real estate in the proposed Revenue ED. [CL418]

   A user stated:

   > We believe that the criteria to determine if a sale has occurred should be consistent with the criteria set forth in the proposed revenue recognition standard. We agree that the sale and leaseback should be connected if entered into simultaneously, but it would appear that the sale should be accounted for under guidance in the proposed revenue recognition standard and the leaseback should be accounted for under the lessee performance obligation approach. As such, it is not clear as to why separate guidance is needed for such transactions in the ED. [CL780]

(b) were concerned about how operational the conditions are and requested additional application guidance.

> 'Clarify:
> + what the term transfers in paragraph 66 of the ED is intended to encompass, i.e. is this meant to be broader than legal sales? In addition, the criterion in paragraph 66(c) of the ED appears overly broad since it would describe literally every circumstance in which a lessee leases an asset that it once owned;
> + the application to non-monetary exchange-leasebacks, spinoff-leasebacks, and contribution-leasebacks' [CL367]
>
> '… we question how to deal with them in practice. The Exposure Draft only lists factors to consider, however, there is no application guidance what extent or degree regarding these criteria hinders to assess a transfer as a sale. … One of the conditions is "the seller-lessee guarantees the buyer-lessor's investment or return on that investment" (paragraph B31b). … Does each leaseback that has a non-cancellable term constitute a buyer-lessor's return that prevents a transaction being sale? If yes, does also a lease term that is minor relative to the remaining useful life of the transferred asset prevent the transaction from being sale? … If a final standard remained that vague in this context we would expect accounting literature to establish the relevant interpretation for sale and leaseback accounting rather than IFRSs, followed by a potential request to IFRIC' [CL107]

10. Many of these respondents proposed that the control-based guidance in the boards' project on revenue recognition (and not the risks and benefits criteria as proposed in the ED) should be applied to determine whether the transfer of the underlying asset qualifies as a sale, regardless of the nature of the underlying asset.

Staff analysis

11. As noted in the cover memo on sale and leaseback transactions, under the boards' proposals the lessee in a sale and leaseback transaction will generally (as opposed to current lease guidance) recognise a right-of-use asset and a liability to make lease payments. Consequently, structuring opportunities to obtain off-balance sheet accounting through sale and leaseback transactions are expected to be significantly reduced when the final leases standard is applied.

12. An analysis of the concerns raised by a majority of the respondents is below.

Consistency with revenue recognition

13. In some cases, the outcome of applying the proposals in the leases ED will be the same as under the revenue recognition proposals. For example, if the seller/lessee has an obligation to repurchase the asset at an amount that is not equal to fair value at the time of the repurchase, paragraph B49 in the revenue recognition ED states that the entity (seller/lessee) has retained control of the underlying asset. This is because the customer (buyer/lessor) is constrained in its ability to direct the use of, and receive benefit from, the underlying asset. Consequently, the seller/lessee would not recognise revenue from the transaction.

14. In other cases, the outcome may not be as clear. For example, when the seller/lessee provides a residual value guarantee to the buyer/lessor:

    (a) If the guarantee is meant to cover most of the economic life of the underlying asset, then a sale would not be recognised when applying either the revenue recognition ED or the leases ED.

    (b) If a seller/lessee leases an asset for 3 years that has a useful life of 25 years and the seller/lessee provides a guarantee of the value of the asset in year 3, the revenue recognition guidance would allow the vendor (seller/lessee) to recognise a sale and the seller/lessee would recognise liability that incorporates the residual value guarantee. However, applying the conditions in the leases ED would result in the transaction being accounted for as a financing and not as a sale.

15. Other conditions in the leases ED that may lead to different accounting to the proposals in the revenue ED relate to the condition that, if a buyer/lessor can compel the seller/lessee to repurchase the asset, a seller/lessee would be precluded from recognising a sale of an asset. This is because paragraph B52 in the revenue recognition ED states that if the customer (buyer/lessor) has a put option, the customer obtains control of the asset, and thus the seller/lessee has lost control of the asset. The revenue recognition ED further states:

    > B53 If the terms of the put and related facts and circumstances make it virtually certain that the customer will exercise the put option, the entity would recognise a repurchase

> liability for virtually the full amount of consideration received from the customer.

Operationality of the conditions

16. Despite the leases ED stating that those conditions 'normally preclude' sale and leaseback transactions, some respondents stated that the proposed conditions in the ED will be the de facto requirements that will preclude most of what they perceive to be genuine sale and leaseback transactions from being accounted for as such and would result in an increased number of transactions, as compared to current practice, being accounted for as financings. For example:

> **Example 1**
>
> Entity A agrees to sell an aircraft 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 5 years to compensate entity B for any decrease in value of the aircraft below CU2000 (its expected market value at the end of year 5). Entity B agrees to compensate entity A if the value of the aircraft exceeds CU2000 at the end of year 5.

17. Applying the conditions proposed in the ED, entity A does not qualify for 'sale' accounting and would continue to recognise the full value of the aircraft to which it has no rights beyond the end of the lease term and to recognising a liability for the full sales proceeds, which may be significantly greater than the obligation that it has assumed under the leaseback.

18. As noted earlier, the conditions in Topic 840 relating to continuing involvement are currently applied very strictly in practice. Practice guidance developed by auditors also led some of them to assert that the conditions proposed in paragraph B31 of the ED may not necessarily be operational. Below are some extracts:

> '… While the FASB considered allowing sale-leaseback accounting for a transaction with minor continuing involvement other than normal leaseback, the FASB rejected that notion because many continuing involvement provisions are not measureable and objectively determinable. Accordingly, any form of continuing involvement other than normal leaseback, even if it is only minor, represents an unacceptable form of continuing involvement that would preclude sale-leaseback accounting.'

'The tests for continuing involvement under paragraph 840-40-25-17 are quite restrictive and go beyond the tests in Topic 360, *Property, Plant, and Equipment*, Subtopic 360-20. The differences between the continuing involvement guidance in Subtopic 840-40 and Subtopic 360-20 may lead to incongruous results.

> Consider the following example:
>
> An entity has owned its headquarters office building for several years. Its cost was $15 million and the property has appreciated. The entity needs more space and has purchased an existing suburban office building. It will take about a year to renovate the new office building, during which the entity will stay in its old building. The entity sells its existing building to an investor for $30 million cash and agrees to lease it back for one year... The lease payment is $3 million, which is a fair rent for the property.
>
> … If the buyer sells the building within three years for more than $30 million, the buyer will pay the entity, in cash, 50% of its profit. If the buyer does not sell the building in three years, the buyer will have the building appraised and will pay the entity, in cash, 50% of any appreciation. If the buyer sells the building at a loss or if the appraisal shows a loss in value, the entity has no liability.

… The entity must keep the building on its books, continue to depreciate the building, and record the $30 million cash received as a liability. Absent the leaseback, Subtopic 360-20 generally would allow recognition of a sale with deferral of profit to the extent of the seller's ownership interest in the buyer…'

Approaches for going forward

19. The staff identified two approaches to address the guidance on what qualifies as a sale in a potential sale and leaseback transaction. For these approaches, if the transaction does not qualify as a 'sale', it will be accounted for as financing. If the transaction meets 'sale' accounting, the seller/lessee will then recognise a right-of-use asset and a liability to make lease payments:
    (a) Approach A (control + risks and benefits): carry forward what was proposed in the ED. This would mean including conditions that set a higher threshold compared to the guidance in revenue recognition to determine whether a sale has occurred.
    (b) Approach B (control): require entities to apply the guidance in revenue recognition to determine whether a sale has occurred and then, if it has, to account separately for the leaseback of the underlying asset.

Approach A (control + risks and benefits)—carry forward what was in the ED

20. Approach A requires an assessment of the transfer of both control and the risks and benefits relating to the underlying asset. It carries forward the conditions that were proposed in the ED on when a transaction should be accounted for as a sale and leaseback.

21. Approach A recognises that, as acknowledged in paragraph B31 of the ED, additional provisions and conditions exist in sale and leaseback transactions that do not exist in 'normal' sale transactions because of the lease element of the transaction.

22. Proponents of Approach A contend that these specific factors that typically are unique to arrangements involving a lease (eg residual value guarantees) should be considered when determining whether the sale arrangement has taken place. They note that, because these factors do not generally exist in sale transactions that are not combined with a lease transaction, it may be appropriate to consider guidance beyond that which is provided for 'normal' sale transactions.

23. Supporters of View A also think that many sale and leaseback transactions, for example real estate transactions where the seller/lessee makes guarantees to the buyer/lessor, are merely an alternative source of financing and should be accounted for as such. Consequently, the threshold to achieve a sale in a sale and leaseback transaction should be set at a higher level than what is proposed in the revenue recognition guidance and it should also take into account the continuing involvement of the seller/lessee. To achieve this objective, proponents of View A support carrying forward the criteria in B31 of the ED that are included in Topic 840-40 in US GAAP, which currently applies to sale and leaseback transactions involving real estate.

24. Supporters of Approach A acknowledge the concerns raised by respondents that these criteria are different from the sales criteria in the revenue recognition project, but they believe that this approach is more useful because it better reflects the economics of the substance of the transaction. In a 'sale and leaseback' that contains a significant level of continuing involvement, it may be better to consider those transactions as financing rather than as a sale and leaseback if the entity derecognises the original asset, recognises a gain and recognises a liability for an asset that it retains a substantial continuing involvement.

25. Proponents of Approach A also note that potential structuring opportunities relating to sale and leaseback transactions might be increased after publication of the ED because of the board's recent tentative decisions to change proposals relating to short-term leases, estimation of the lease period and measurement of variable lease payments.

Approach B (control)—applying the guidance in revenue recognition

26. Approach B is to require the vendor (potential seller/lessee) to apply the requirements in the revenue recognition project to determine whether it has sold the underlying asset, and if control has passed (ie there is a sale), the entity would then account separately for the leaseback of the underlying asset. If there is no sale, then the entire transaction will be considered as financing.

27. The revenue recognition project proposes that an entity (potential seller/lessee) should evaluate the terms of the contract and its customary business practice to:

    (a) identify the good or service that the entity promises to transfer to the customer (potential buyer/lessor); and

    (b) determine whether each promised good or service should be accounted for as a separate performance obligation.

28. In applying the revenue recognition approach to a sale and leaseback transaction, the conclusion on whether the transaction should be accounted for as a sale will depend on the facts and circumstances in the contract and on whether control of the underlying asset passes from the transferor to the transferee.

29. Furthermore, the additional risk and benefits conditions that were proposed in the leases ED were based on a revenue recognition principle in US GAAP that is proposed to be deleted as part of the FASB's consequential amendments on revenue recognition:

> 4. Statement 66[1] requires that a sale transaction be considered consummated before it is appropriate to recognize a sale. Consummation of a sale requires that (a) the parties are bound by the terms of a contract, (b) all consideration has been exchanged, (c) any permanent financing for which the seller is responsible has been arranged, and (d) all conditions precedent to closing have been performed.… . [Now in Topic 360 *Property, plant and equipment*, paragraphs 360-20-40-5 and 7]
>
> 5. Consummation of a sale under Statement 66 would normally provide for the transfer of title to the buyer. Statement 13, on the other hand, allows a sale to be recognized in a sales-type lease of real estate even when title is never transferred provided that the transaction qualifies for the full accrual method of profit recognition. This Statement eliminates that inconsistency by requiring the transfer of title to the buyer for a transaction to qualify as a sales-type lease of real estate. [paragraphs 4 & 5 FAS 98 *Accounting for Leases: Sale-leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term and Initial Direct Costs of Direct Financing Leases.*] [Now in Topic 840 *Leases*, paragraph 840-10-25-43 (a)]

[1] Statement 66 deals with the accounting for sales of real estate.

30. If the boards want to continue to be consistent with the guidance in FAS 66 (which is now incorporated in Topic 840) for determining whether a transaction qualifies as a sale, it would be inconsistent with the direction of the revenue recognition project.

31. Some might consider that applying approach B would mean that preparers will have less guidance on which type of transactions should be accounted for as sales and which type of transactions should be accounted for as a financing.

32. However, supporters of Approach B question why it is necessary to require additional conditions for identifying a 'sale' in a sale and leaseback transaction compared to identifying a regular sale by applying the guidance in the revenue recognition project. They note, for example, that the boards have not included additional conditions for recognising a sale of an asset to a related party yet the boards want to do so for a sale and leaseback.

33. Requiring entities to apply the requirements in the revenue recognition project would result in:

    (a) consistent application for 'sale' accounting. It would thereby improve comparability irrespective of whether the seller will be a lessee of the underlying asset.

    (b) less complexity for preparers on when control is obtained/transferred.

    (c) consistency with the boards' tentative decision on sale and purchase that the entity should apply the guidance in revenue recognition to determine whether the entity has transferred, or obtained control of, the asset.

    (d) more types of transactions qualifying for sale and leaseback accounting compared to what was proposed in the ED rather than being accounted for as financings.

    (e) some also think that allowing the entity to recognise the gain on the sale of the asset would also inform users of the fair value of the asset that had been sold.

34. Supporters of Approach B also note that some of the structural concerns relating to sale and leaseback transactions that exist in current US GAAP and IFRSs would be reduced by application of the final leases standard, because of the proposed requirement to recognise assets and liabilities for all lease contracts (with the exception of certain short-term leases).

Staff recommendation and question

35. A majority of the staff recommend Approach B, which would require the entity (vendor or possible seller/lessee) to apply the requirements in the revenue recognition project to determine whether a transaction includes a sale of the underlying asset. Those staff members think:
    (a) it would result in a more consistent application of 'sale' accounting. Thus it would improve comparability for users irrespective of whether the seller will lease the asset. This would also result in less complexity for preparers when determining when control is obtained/transferred. It would also make application of the leases standard less complicated.
    (b) it better reflects the economics of the transaction compared to what was proposed in the ED.
    (c) structuring opportunities relating to sale and leaseback transactions would be significantly reduced because of the requirements in the ED to recognise assets and liabilities relating to the 'leaseback' element of the transaction.

36. In addition, supporters of Approach B also think that if the boards support Approach B, additional disclosures should be made when the entity enters into a sale and leaseback transaction to ensure that users are aware of any gains made and of the conditions attached in that transaction.

37. A minority of the staff recommend Approach A. They think that Approach A better reflects the substance of the transaction and provides better information, particularly when there is significant continuing involvement in the transaction. Supporters of Approach A think that unique conditions may exist

in a contract that combines sale and leaseback elements and that, to address these unique conditions, additional guidance beyond that which is provided in the revenue recognition guidance should be provided.

38. An analysis of disclosures relating to sale and leaseback will be provided at a future meeting.

Question
All the staff recommend that when the sale has occurred, the arrangement would be accounted for as a sale and a leaseback. If a sale has not occurred, then the arrangement would be accounted for as a financing. The majority of the staff recommend Approach B—an entity should apply only the control criteria in revenue recognition to determine whether a sale has occurred in a sale and leaseback transaction. A minority of the staff recommend that additional risk and benefits conditions should be provided, in addition to the control criteria proposed in revenue recognition, to determine whether a sale has occurred in a sale and leaseback transaction (Approach A). Which approach do the boards support?

Appendix A

The preliminary draft wording in this appendix has been prepared by the staff to help the boards in reaching decisions discussed in this paper. New text is underlined and deleted text is struck through.

Sale and leaseback transactions

66. If a transferor transfers an asset to another party and leases that asset back from that other party, both the transferor and the transferee shall account for the transfer contract and the lease contract in accordance with paragraphs 67- 69 if the contracts are:
    (a) entered into at or near the same time;
    (b) negotiated as a package with a single commercial objective; or
    (c) performed either concurrently or consecutively.

67. The transferor shall account for transactions that meet the criteria in paragraph 66 as follows:
    (a) If the transfer meets the conditions for a sale (see *Revenue from Contracts with Customers*~~paragraphs B9, B10 and B31~~), the transferor shall account for the sale in accordance with applicable IFRSs/ Topics and for the lease in accordance with paragraphs 10-27.
    (b) If the transfer does not meet the conditions for a sale, the transferor shall account for the contract as a financing. The transferor shall not derecognise the transferred asset and shall recognise any amounts received as a financial liability.

68. The transferee shall account for transactions that meet the criteria in paragraph 66 as follows:
    (a) If the transfer meets the conditions for a purchase (see *Revenue from Contracts with Customers*~~paragraphs B9, B10 and B31~~), the transferee shall account for the purchase in accordance with applicable IFRSs/Topics … (see paragraphs 30−45).
    (b) If the transfer does not meet the conditions for a purchase, the transferee shall not recognise the transferred asset. The transferee shall recognise the amount paid as a receivable in accordance with applicable IFRSs/US GAAP.

Paragraph B31 in the ED, in which the boards discussed the additional conditions under which a sale and leaseback may not result in the transfer for a purchase or sale, is proposed to be deleted.