Staff Paper

[This box can be used to give additional meeting dates, for example if the paper is also being discussed at a FASB education session]

Project **Leases**

Topic **Sale and leaseback transactions: recognition of gains/losses**

Purpose

1. This paper discusses:

   (a) how a seller/lessee should recognise a gain or loss arising on a transaction that is accounted for as a sale and leaseback.

   (b) how a seller/lessee should determine a gain or loss arising on a sale and leaseback transaction when it is not at fair value.

2. This paper does not consider transition accounting for sale and leaseback transactions. That issue would be considered at a later meeting and would analyse the accounting for deferred gains and losses arising on sale and leaseback transactions before the effective date of the proposed leases standard.

3. Appendix A includes preliminary text to be included in the proposed standard. Because we are recommending the boards confirm its decisions in the *Leases* exposure draft (ED), we propose carrying forward what was included in the ED.

Background information

4. In a sale and leaseback transaction, 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 following table summarises the effect that a sale or leaseback at other than a market rate could have on the recorded assets and liabilities. (Note: the boards have not completed their redeliberations on the lessor accounting model proposed in the ED.)

	Seller/lessee	**Buyer/lessor**
Sales proceeds are greater than fair value **Leaseback is at above market rates**	• Any gain on disposal will be overstated • Any loss on disposal will be understated • The right-of-use asset will be overstated	• The carrying amount of the property may be overstated • TBD: the effect of the leaseback depends on the lessor model
Sales proceeds are less than fair value **Leaseback is at below market rates**	• Any gain on disposal will be understated • Any loss on disposal will be overstated • The right-of-use asset will be understated	• The carrying amount of the property may be understated • TBD: the effect of the leaseback depends on the lessor model

Proposals in the ED

5. The ED proposed that if the consideration for a purchase or sale or the lease payments specified by the leaseback are at fair value, and the transaction meets the conditions for a sale, then the seller/lessee will account for the sale in accordance with applicable requirements.

6. The ED also proposed that if the consideration for a purchase or sale or the lease payments specified by the leaseback are not at fair value:

   (a) A transferor [seller/lessee] shall adjust:

(i) the measurement of the right-of-use asset to reflect current market rates for lease payments for that asset.

(ii) the gain or loss on disposal of the underlying asset by any difference between the present value of lease payments based on the terms specified in the lease and the present value of the lease payments based on current market rates.

(b) A transferee [seller/lessee] shall adjust the carrying amount of the underlying asset and the lease liability it recognises under the performance obligation approach to reflect current market rates for the lease payments for that lease.

7. The boards' rationale for these adjustments is that they would ensure that the assets, liabilities, gains and losses recognised by both lessee and lessor are neither understated nor overstated.

8. The boards considered requiring entities to defer gains and losses that arise from a sale and leaseback transaction. However, in paragraph BC164 of the ED, the boards determined that deferring gains or losses is inconsistent with the boards' conceptual frameworks and would increase the complexity of the proposed requirements.

Feedback received

9. A few respondents were concerned with the proposals and recommended that the seller/lessee should recognise profit or loss on the sale and leaseback transaction over the lease term, rather than on an up-front basis.

> ... In the case of a sale leaseback transaction, we prefer the method of deferring any gain on sale of the asset over the lease term as a reduction of the amortization expense relating to the right of use asset. This deferred gain would be grouped with the present value of the lease payments over the legal term to establish the lease liability. [CL496]

Staff analysis and questions to the boards

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

11. We considered if the seller/lessee should defer all gains or losses over the lease term irrespective of whether the transaction was at fair value. Such approaches could be:

    (a) recognising gains over the lease term but recognising all losses on the sale transaction upfront. We rejected this approach because it is not consistent with the qualitative characteristic of faithful representation where information must be neutral.

    (b) recognising all gains or losses over the lease term if the leaseback is a financing-type lease, consistent with existing requirements.

12. We rejected those approaches and recommend the boards to confirm their proposals in the ED:

    (a) Where the sale and leaseback transaction results in a sale of the underlying asset and the leaseback are established at fair value, gains and losses arising from the transaction should not be deferred.

    (b) Where the sale and leaseback transactions are not established at fair values, the assets, liabilities, gains and losses recognised upfront should be adjusted to reflect current market rentals.

13. This is because:

    (a) Deferring income may not meet the definition of a liability and is inconsistent with the proposals in the revenue recognition project;

    (b) The boards' proposals ensure that assets, liabilities, gains and losses recognised by both the buyer/lessor and seller/lessee are neither under nor overstated; and

(c) It would lead to consistent accounting for all leases (by both the lessee and lessor) and promote comparability across different types of leases.

Question 1
We recommend that in a sale and leaseback transaction when consideration is at fair value, gains or losses arising from the transaction should not be deferred. Do the Boards agree? If not, what alternative approach would you recommend and why?

Question 2
We recommend that in a sale and leaseback transaction when consideration is not established at fair value, the assets, liabilities, gains and losses recognised should be adjusted to reflect current market rentals. Do the boards agree? If not, what alternative approach would you recommend and why?

Appendix A *Preliminary draft wording*

The preliminary draft wording in this appendix has been prepared by the staff to help the boards in reaching decisions discussed in this paper. Because we recommend carrying forward the boards' decisions in the ED, there is no proposed changes from what was proposed in the ED.

69. If the consideration for the purchase or sale or the lease payments specified by the leaseback are not at fair value:

(a) a transferor shall adjust:

(i) the measurement of the right-of-use asset to reflect current market rates for lease payments for that asset.

(ii) the gain or loss on disposal of the underlying asset by any difference between the present value of lease payments based on the terms specified in the lease and the present value of the lease payments based on current market rates.

(b) …. [TBD, pending discussion on lessor accounting]