Project	**Leases**
Topic	**Sale and leaseback transactions: partial asset or whole asset approach**

Purpose

1. This paper discusses whether to apply the partial asset or whole asset approach in a sale and leaseback transaction.

Background

2. In a sale and leaseback transaction, one entity (the lessee) transfers an asset that it owns to another party (the lessor) and then leases back that same asset. Before the leases exposure draft (ED) was issued, the boards had considered whether the transferred asset must be an entire leased asset (a 'whole asset' approach) or whether a bundle of rights and obligations associated with an asset could qualify for sale and leaseback treatment (a 'partial asset' approach).

3. The ED proposed that the transferred asset should be viewed as a 'whole asset' (the entire leased asset). The boards rejected a 'partial asset' approach (where a bundle of rights and obligations associated with an asset could qualify for sale and leaseback treatment) because they viewed it as being more complex than the whole asset approach without giving proportionate benefit to users of financial statements. (BC161 of the ED)

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4. To maintain consistency with the 'whole asset' approach and because the lessor is expected to retain exposure to significant risks and benefits that are associated with the underlying asset, the boards proposed that the buyer/lessor would apply the performance obligation approach to the leaseback (paragraphs 68(a) and BC166 of the ED).

5. Under a 'partial asset' approach, the seller/lessee would continue to recognise a portion of the underlying asset that represents its right to use the underlying asset during the leaseback and derecognise that portion of the underlying asset relating to its right transferred to the buyer/lessor.

> Example
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> Entity A sells a four-storey building to entity B. The remaining useful life of the building is 50 years. Entity A leases the ground floor of that building from Entity B for 5 years.

6. Under the 'whole asset' approach, entity A would derecognise the entire building and recognise a right-of-use asset relating to the ground floor for five years.

7. Under the 'partial asset' approach, entity A would derecognise the three floors and 45 years of the ground floor.

Feedback received

8. Most respondents agreed with a whole asset approach for sale and leaseback transactions. For example:

> We agree with the treatment for lessees in a leaseback transaction, according to which if the transfer meets the definition of a sale, the seller/lessee will derecognise the asset and will recognise the lease based on the proposals in the ED; and if the transfer does not meet the definition of a sale, the seller/lessee will not derecognise the asset and will recognise a financial liability. [CL186]
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> We agree with the lASB's treatment for lessees in a sale/leaseback transaction, according to which if the transfer meets the definition of a sale, the seller/lessee will derecognise the asset and will recognise the lease based on the proposals in the ED; and if the transfer does not meet the definition of a sale, the seller/lessee will not derecognise the asset and will recognise a financial liability. [CL645]

9. A minority of respondents disagreed with the boards' reasons for adopting a whole asset approach and supported a partial asset approach. Those respondents, who included standard-setters and industry associations, asserted, in support of the partial asset approach, that the sale of the underlying asset by the seller/lessee in a sale and leaseback transaction should be accounted for similarly to how a lessor would account for a lease of the underlying asset when applying the derecognition approach proposed in the ED:

> We consider that the proposed model for sale and leaseback transactions is not consistent with the premise of the right-of-use model that the asset is a bundle of rights and obligations. The only model for sale and leaseback transactions that would be consistent with this premise is to account for sale and leaseback transactions under a ('partial') derecognition approach. We therefore urge the IASB to reconsider its decision to abandon this approach. [CL682]

> We support … the conceptual premises that an asset is a bundle of rights that can be separated should apply in the case of sale and leasebacks too. In this context, the seller/lessee is transferring only the residual rights to use the asset after the lease term has expired to the purchaser/lessor, and retains a right to use the asset during the lease term. These rights can easily be determined using the de-recognition methodology. The decisive element in determining whether the residual asset should be derecognised from the financial statements of the seller/lessee should be whether control of the residual has been transferred to the purchaser/lessor, as defined in the revenue recognition guidance. [CL449]

Staff analysis

10. The following table compares the accounting for seller/lessee and buyer/lessor under the 'partial asset' approach and the 'whole asset' approach in a sale and leaseback transaction and also compares them with a financing arrangement.

11. Appendix A illustrates the differences between a 'whole asset' approach and a 'partial asset' approach in a simple sale and leaseback transaction. It illustrates the differences in the financial statements when the two approaches are applied.

	Whole asset (ED)	Partial asset	Financing
Seller/ lessee	Derecognise whole underlying asset Recognise right-of-use asset and liability to make lease payments # Gain/loss on sale*	Derecognise the portion of the underlying asset related to the lease Recognise right-of-use asset and liability to make lease payments # ^ Gain/loss on sale*	Not derecognise the leased asset Recognise proceeds received as a financial liability No gain/loss on sale (interest expense will be reflected over the lease term)
Buyer/ lessor	Recognise the entire underlying asset (the whole asset) Recognise receivable and a lease liability or a residual asset ~	Recognise an asset for the rights relating to the underlying asset that have not been leased-back Recognise receivable Recognise a residual asset or lease liability ~ Income/expense if applying the derecognition approach	Not recognise leased asset Recognise receivable for proceeds paid

* In this table, we have assumed that the sale and leaseback transactions are at fair value and that there is no gain or loss on the sale and leaseback transaction. Agenda paper 11E/FASB Memorandum 149 addresses how to account for profit/loss when the sale and leaseback transaction is not at fair value.

\# The lessee will recognise a liability to make lease payments that will include options when there is a significant economic incentive for an entity to exercise the option and recognised variable lease payments.

^ If the carrying amount of the underlying asset is different from the fair value of the underlying asset, the right-of-use asset will be less than the liability to make lease payments. This differs from the ‘whole asset’ approach, where the seller/lessee is assumed to sell the entire asset and recognises a right-of-use asset and liability to make lease payments that is a reasonable approximation to fair value.

Implications of either approaches

12. The table below summarises the implications of the ‘whole asset’ and ‘partial asset’ approaches and the results of the illustration in Appendix A.

Issues	Whole asset	Partial asset
Gain/loss on day 1	The seller/lessee recognises gain/loss equal to the difference between the carrying amount of the underlying asset and its fair value.	Gain/loss recognised is limited to the portion of the asset that is not leased back by the seller/lessee (ie no gain is recognised on the portion of the asset retained as the lessee's right-of-use asset).
More sale leaseback transactions? (This also depends on the boards' decision on how to determine the criteria for sale and leaseback transactions (see Agenda Paper 11D/FASB Memo 148).	Fewer transactions will qualify as sale and leasebacks. The seller/lessee will have to determine whether it has lost control in regard to the entire asset rather than determining whether it has lost control of the portion of the asset that has been transferred to the buyer/lessor.	More transactions will qualify as sale and leasebacks. This is because the seller/lessee will determine whether it has lost control in regard to the portion of the asset that it transferred to the buyer/lessor rather than considering the entire asset.
Consistency with concept behind the partial derecognition approach in lessor accounting	Not consistent.	Consistent with the partial derecognition approach proposed for lessor accounting in the ED, where the asset is considered to be a bundle of rights and the entity derecognises portions of the asset when it loses control.
Consistency with the application of purchase and sale accounting of property, plant and equipment	Consistent with accounting for the purchase and sale of a good in non-lease projects. In these situations, the assessment is performed at the underlying asset unit of account level. This is different to the bundles of rights unit of account applied in the leases project	Generally not consistent with the current unit of account applied in accounting for the purchase and sale of property, plant and equipment.

Issues	Whole asset	Partial asset
Complexity	Less complex to apply	More complex, particularly if the seller/lessee applies the proposed non-financing type of lease accounting approach to the leaseback (see the illustration in Appendix A).

Staff recommendations and question to the board

13. The majority of the staff recommend that the boards should confirm their proposals in the ED to apply the 'whole asset' approach because it is less complex, particularly if there is a non-financing lessee model for the leaseback.

14. These staff think that the 'whole asset' approach is consistent with how a seller/lessee would apply the revenue recognition guidance to determine whether they have a sale of a good, such as an item of property, plant and equipment. They also think that the 'whole asset' approach is consistent with how the buyer/lessor would apply guidance such as property, plant and equipment accounting to determine whether they have acquired a good, such as the underlying asset.

15. The members of staff who support the 'whole asset approach' think that the seller/lessee and buyer/lessor should first determine whether they have a purchase or sale of the underlying asset before they apply lease accounting guidance. These staff also note that the ED requires a lessor in a sale and leaseback transaction to always apply the performance obligation (which is more of a 'whole asset approach'), rather than a derecognition approach.

16. These staff also observe that most sale and leaseback transactions occur in the real estate industry and think that applying the partial asset approach to these transactions may not provide useful information to users.

17. A minority of staff support the 'partial asset approach' noting that because most sale and leaseback transactions occur for higher-value transactions they think that it is unlikely that the seller/lessee is unaware what the fair value of underlying asset is (otherwise, they would not be selling the underlying asset).

18. They also think that if the boards considered partial derecognition to be a viable model for lessor accounting (the partial derecognition approach is based on the premise that an asset is a bundle of rights and that the lessor derecognises the portion of the asset that it no longer retains, and the costs in requiring entities to apply it), the boards should be consistent with that decision and apply the 'partial asset' approach in a sale and leaseback. Consequently, they recommend the 'partial asset' approach.

Question to the boards

Question
Should the seller/lessee apply the 'whole asset' approach or the 'partial asset' approach?

Appendix A
Illustrative example for the ‘whole asset’ and ‘partial asset’ approaches for lessee and lessor accounting models

A1. This appendix is *only to illustrate* how a sale and leaseback transaction will affect the entity’s financial statements using a simple leaseback scenario.

A2. We have not considered whether the leaseback qualifies under a specific type of lessee or lessor accounting approach as currently considered by the boards. The impact on the financial statements is based on the boards’ tentative decisions to date for each approach.

> Example
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> Entity A owns an office building that has a carrying amount of CU700 and a fair value of CU1,000. The remaining useful life of the building is 20 years. Entity A agrees to sell the building to entity B for CU1,000. At the same time, entity A leases the building back from entity B for 5 years. Annual lease payments on the leaseback are CU85. Entity A’s incremental borrowing rate is 10%
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> The present value of the lease payments is CU322.

Whole asset approach

A3. Accounting by the seller/lessee (entity A)

On the sale and leaseback date:

DR	Cash	1,000	
CR	Building		700
CR	Gain on sale		300

(To recognise a sale of a building)

DR	Right-of-use asset	322	
CR	Liability of pay for lease payments		322

(To recognise leaseback)

	Year						
	0 Pre-sale	0 Post-sale	1	2	3	4	5
Statement of financial position (financing lease)							
Building	700						
Cash		1,000	915	830	745	660	575
Right-of-use asset		322	258	193	129	64	-
Liability to make lease payments		-322	-269	-211	-148	-77	-
Net assets	700	1,000	903	812	726	647	575

Statement of financial performance	0	1	2	3	4	5	Total
Financing leases							
Gain	300						300
Amortisation		-64	-64	-64	-64	-64	-322
Interest		-32	-27	-21	-15	-8	-103
Profit/loss	300	-97	-91	-86	-79	-72	-125
Non-financing leases							
Gain	300						300
Total lease expenses		- 85	- 85	- 85	- 85	- 85	- 425
Profit/loss	300	- 85	- 85	- 85	- 85	- 85	- 125

Partial asset approach

A4. Accounting by the seller/lessee (entity A)

Building retained[1] = PV of receivable x carrying amount of building / fair value of the building
= CU322 x CU700 / CU1,000
= CU225

Portion of building to be derecognised = CU700 – CU225 = CU475

DR	Cash	1,000	
DR	Cost of sales	797	
CR	Building		475
CR	Liability to pay for lease payments		322
CR	Revenue		1,000

Gain on sale
= 1000 – (475 + 322)
= 203

(To recognise a sale and leaseback of a building using the 'partial asset' approach)

	Year							
	0 Pre-sale	**0 Post-sale**	**1**	**2**	**3**	**4**	**5**	
Statement of financial position								
Building (ROU asset)	700	225	180	135	90	45	-	
Cash		1,000	915	830	745	660	575	
Lease liabilities		- 322	-269	-211	-148	-77	-	
Net assets	700	917	840	769	704	645	594	
Statement of financial performance								Total
Financing leases								
Gain		203						203
Amortisation			-45	-45	-45	-45	-45	-225
Interest expense			-32	-27	-21	-15	-8	-103
Profit/loss		203	-77	-72	-66	-60	-53	-125
Non-financing leases								
Gain		203						203
Unwinding of gains (at 7.45%)		0	17	18	19	20	21	97
Lease expense			-85	-85	-85	-85	-85	-425
Profit/loss		203	-68	- 67	-66	-64	-63	-125

[1] This ratio is similar to how a partial derecognition approach works.

Partial asset approach—lessee accounting implications

A5. If the transaction is accounted for as a partial sale and the leaseback element of the transaction is accounted for as a financing-type of lease, measurement of the portion of the asset retained by the seller/lessee will be based on the historical cost carrying amount of the entire asset, prior to the partial sale. The measurement of the portion of the asset that is retained will be different from the measurement of the liability to make lease payments if the carrying amount of the entire underlying asset prior to the partial sale is different from the fair value. This difference reflects that measurement of the retained asset reflects a portion of the historical cost of the entire building.

A6. The seller/lessee would then reclassify the retained asset to a right-of-use asset. The depreciation of the right-of-use asset will be less under the 'partial asset' approach than the depreciation of the right-of-use asset when the 'whole asset' approach is applied to the original sale transaction. (In this example, the depreciation charge is CU45 under a 'partial asset' approach vs CU64 under a 'whole asset' approach.)

A7. If the transaction is accounted for as a partial sale and the leaseback element of the transaction is accounted for as a non-financing type of lease, an adjustment is needed because of the difference between the liability to make lease payments and the carrying amount of the reclassified right-of-use asset. This is because the future lease expense is based on the liability to make lease payments and consequently the value of the right-of-use needs to be either revalued to its fair value (to ensure that the ROU asset = the liability to make lease payments on day 1) or the value of the right-of-use asset needs to be accreted over the term of the leaseback. The accretion in the five years would be where the seller/lessee is recognising the unrealised gain on the building.