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Project	**Leases**		
Paper topic	Sweep issue—sale and leaseback transactions		
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Background

1. At the 22-23 March 2011 joint meeting, the boards tentatively decided the following regarding sale and leaseback transactions:

    (a) If a sale has occurred, the transaction is accounted for as a sale and then a leaseback of the entire underlying asset. If a sale has not occurred, the entire transaction would be accounted for as a financing arrangement.

    (b) An entity should apply the control criteria proposed in the Revenue recognition project to determine whether a sale has occurred.

    (c) When the consideration for the sale is at fair value, the gain or loss arising from the transaction should be recognised when the sale occurs.

    (d) When the consideration is not at fair value, the assets, liabilities, and gain or loss recognised should be adjusted to reflect current market rentals.

2. The decision to apply the control criteria proposed in the Revenue recognition project to determine whether a sale has occurred was a change from what was proposed in the 2010 Exposure Draft *Leases* (the 2010 ED). The 2010 ED had included a list of conditions that, if they existed, would typically preclude sale and

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leaseback accounting. Those conditions set a higher threshold in terms of achieving sale accounting than the revenue recognition proposals.

3. The boards decided to change the proposals regarding sale and leaseback transactions to align the assessment of whether a sale had occurred with the proposals in the Revenue recognition project, in response to the following concerns raised by respondents to the 2010 ED:

    (a) Many respondents, including some users, disagreed with the proposals. Most of them questioned why there was a need for a higher threshold in relation to sale and leaseback transactions. Many noted that the higher threshold for revenue recognition that exists in US GAAP for real estate sales no longer exists in the revenue recognition proposals. Consequently, they questioned why a higher threshold for revenue recognition should be retained only within the context of sale and leaseback transactions.

    (b) Many respondents were also concerned about whether the sale recognition conditions in the 2010 ED were operational. Because of the expected difficulty in applying the conditions, many expected practice to take a very strict stance on application with almost all sale and leaseback transactions being treated as financing arrangements. However, many of these respondents thought that applying sale and leaseback accounting was an appropriate way to account for many transactions structured as sale and leaseback arrangements.

4. In reaching the revised decisions, the boards also noted that applying the proposals in the Revenue recognition project to sale and leaseback transactions would simplify the proposals and increase comparability, which would be beneficial to both preparers and users of financial statements. Some of the structuring concerns relating to sale and leaseback transactions that exist today would also be reduced by the leases standard, because it would introduce the recognition of lease assets and liabilities by lessees for all leases (with the exception of short-term leases).

Objective of this paper

5. When considering the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers* (2011 Revenue ED), together with the boards' tentative decisions regarding sale and leaseback transactions, some questions have been raised about how the boards intend the revenue recognition guidance to apply within the context of sale and leaseback transactions.

6. The objective of this paper is to address those questions and the possible clarifications that could be included in the revised *Leases* Exposure Draft to assist preparers in accounting for these transactions. We are **not** asking the boards to reconsider their previous decisions regarding sale and leaseback transactions, and, therefore, the staff analysis and recommendations are made in light of the decisions that the boards have already made.

Questions raised relating to the accounting for sale and leaseback transactions

7. The overriding accounting issue that arises in sale and leaseback transactions is: when an entity sells an asset and then immediately leases it back, should the entity be permitted to account for the transaction as a sale and leaseback, or should the entire transaction be accounted for as a financing arrangement? Accounting for the transaction as a sale and leaseback can result in the seller/lessee recognising a gain on the transaction (which could arise if the asset is measured on a cost basis and the cost-based carrying amount of the asset is lower than its fair value) even though they are continuing to use the underlying asset following the sale. Accounting for the transaction as a financing arrangement would result in no gain or loss recognition. The seller/lessee would retain the asset on its balance sheet, and any cash received by the seller/lessee would be treated as a financial liability to be repaid to the buyer/lessor over a specified future period.

8. As previously stated, the boards have tentatively decided that a seller/lessee in a sale and leaseback transaction would first determine whether the revenue recognition criteria, based on control, in the 2011 Revenue ED have been met.

The following questions have been raised relating to the application of the control criteria in the 2011 Revenue ED to sale and leaseback transactions:

(a) Are the control criteria in the revenue recognition guidance applied to the entire sale and leaseback transaction or only to the sales portion of the transaction?

(b) If applied only to the sales portion of the transaction, would all transactions be accounted for as sale and leaseback transactions?

(c) If applied to the entire transaction, would all sale and leaseback transactions be accounted for as financing arrangements?

(d) How is a sale and leaseback transaction accounted for if it includes an unconditional right for the seller/lessee to repurchase the asset (ie a call option) with an exercise price below the original selling price of the underlying asset?

Staff analysis

Is the revenue recognition guidance applied to the entire transaction or only the sales portion of the transaction?

9. When applying the guidance developed in the Revenue recognition project, an entity determines how to account for a sale and leaseback transaction by assessing whether the buyer/lessor obtains control of the underlying asset. The staff think that an entity should carry out this assessment by looking to the terms of the entire transaction, rather than just the sales portion of the transaction.

10. There are a number of reasons for this conclusion:

(a) The first is that we think this approach reflects the boards' intentions in reaching their tentative decisions regarding sale and leaseback transactions. The terms and features of a sale and leaseback transaction are negotiated as a package. The boards tentatively decided that, when determining how to account for that transaction, an entity assesses whether the buyer/lessor obtains control of the underlying asset

consistently with how other sale transactions are assessed for revenue recognition. We think that the only way to ensure consistency in applying the revenue recognition proposals is to apply them to the entire transaction.

(b) The second reason is that it could be difficult and arbitrary to bifurcate the transaction into a distinct sales portion and leaseback portion. A requirement to evaluate each contract separately might permit an entity to structure the arrangement to achieve a particular accounting outcome. For example, if the transaction includes a call option giving the seller/lessee the unconditional right to repurchase the underlying asset, should the call option be attached to the sales portion of the transaction or to the leaseback portion of the transaction? Would the answer depend upon which contract includes the call option, if the transaction was structured in two separate contracts? Some might think that the option should be considered part of the sales portion of the transaction. If the seller can *repurchase* the underlying asset, they would conclude that the feature should be linked to selling the asset. However, others might disagree. Call or purchase options are common features of many leases, and the intention of including the call option may be to put the seller/lessee in exactly the same position as any other lessee leasing a similar underlying asset. Consequently, they might argue that features such as call/purchase options should be attached to the leaseback portion of the transaction.

(c) The third reason is that applying the revenue recognition guidance to only the sales portion could result in almost every transaction structured as a sale and leaseback transaction achieving sale accounting. Because of the difficulty noted above regarding splitting the transaction into distinct sale and leaseback portions, any feature of the transaction that might prevent the recognition of revenue under the revenue recognition guidance could be argued to be part of the leaseback portion. Such an

approach might give an entity the ability to recognise a gain and increase the carrying amount of its assets whenever it chooses.

Has a sale occurred in any sale and leaseback transaction?

11. Some have suggested that a conclusion that the revenue recognition guidance should be applied to the entire transaction could result in *all* sale and leaseback transactions being treated as financing arrangements. This is because they question how the buyer/lessor could be deemed to obtain control of the underlying asset when, as part of the same transaction, the seller/lessee obtains the right to control of the use of the underlying asset for a period of time (the definition of a lease according to the boards' proposals). Control of an asset is defined in the revenue recognition guidance as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Because the sale and leaseback portions of the transaction are negotiated as a package, it could be argued that the buyer/lessor does not have the ability to independently direct the use of the asset, and nor can it decide to have access to the economic benefits generated from use of the asset during the lease term. Accordingly, because of the existence of the leaseback, the buyer/lessor does not obtain control of the underlying asset.

12. The staff do not think that the boards' intentions were to preclude sale and leaseback accounting for all transactions, and nor do we think that this will be the outcome. In our view, the existence of the leaseback does not, in isolation, prevent the buyer/lessor from obtaining control of the underlying asset. This is because a lease is different from the purchase or sale of an asset. A lease does not transfer **control** of the underlying asset to the lessee; instead, it transfers the right to **control the use** of the underlying asset **for the term of the lease**.

13. Consequently, assuming that there are no other features in a sale and leaseback transaction that would prevent concluding that a sale has occurred in accordance with the revenue recognition proposals, we think it is appropriate for the buyer/lessor to be considered to:

(a) obtain control of the underlying asset; and

(b) immediately transfer the right to control the use of that asset to the lessee for the lease term.

14. Although the seller/lessee obtains substantially all of the benefits from use of the underlying asset **during the lease term**, this does not prevent the buyer/lessor from having control of the underlying asset. The lease payments received by the buyer/lessor during the lease term, together with the benefits that the lessor can generate from the residual asset after the lease term, would represent substantially all of the remaining benefits from the asset immediately before the asset is leased to the seller/lessee. In addition, the buyer/lessor can often decide to sell the underlying asset during the lease term, which also indicates the buyer/lessor has control of the underlying asset and is entitled to the remaining benefits of the asset.

15. We think that the buyer/lessor in many sale and leaseback transactions is no different from many other lessors in terms of their control of the underlying asset. Many lessors purchase an asset that will be the subject of a lease from a third party only when the terms of the lease have already been negotiated. The lessor may not receive physical possession of the asset until the end of the lease term. Particularly for some equipment leases, the lessee receives the equipment directly from the manufacturer and the lessor may never take possession of the equipment, even though the lessor purchases the asset from the manufacturer. In a sale and leaseback transaction, the lessor also may not receive physical possession of the asset until the end of the lease term. However, the staff think that, in both situations, it is appropriate to consider the lessor as controlling the underlying asset.

Does a sale occur in all sale and leaseback transactions?

16. If the boards agree with the staff's view set out in paragraphs 11-15 above, some may think that this could result in almost all sale and leaseback transactions being

accounted for as such, in the absence of, for example, a call option that would prevent sale accounting according to the revenue recognition guidance.

17. Consider an example in which a seller/lessee sells a building to a buyer/lessor and leases that building back for 40 years, which is all of the remaining economic life of the building. The lease payments made to the lessor over the 40-year lease term equal the entire amount that the lessor has paid for the building, plus a return on that investment. There is a risk that such a sale and leaseback transaction, which is entered into solely for financing purposes or to enable the seller/lessee to recognise a gain, could be accounted for as a sale and leaseback transaction when the seller/lessee would continue to control the use of the asset for the duration of the asset's life.

18. We think that the boards' tentative decisions regarding sale and leaseback transactions should not lead to accounting for the example set out in paragraph 17 as a sale and leaseback transaction. This is because we do not think a sale has occurred when applying the revenue recognition guidance to the entire transaction. In the example in paragraph 17, the seller/lessee retains the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset via the leaseback. The transaction, in effect, is a sale and 'saleback' and, as such, a sale has not occurred. The transaction would be accounted for as a financing arrangement.

19. In saying that, we acknowledge that there is a risk that. without any additional guidance. some arrangements similar to the example in paragraph 17 could be accounted for as sale and leaseback transactions. In addition, the lack of additional guidance might increase cost and complexity.

20. Consequently, we recommend including in the revised *Leases* ED a clarification that when the seller/lessee retains the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset, the seller/lessee retains control of the asset and should account for the entire transaction as a financing transaction.

21. In terms of applying that principle, we recommend specifying in the revised ED that, for the purposes of a sale and leaseback transaction, a seller/lessee would be assumed to have the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset if:

    (a) the lease term is for the major part of the economic life of the underlying asset; or

    (b) the present value of the minimum lease payments accounts for substantially all of the fair value of the underlying asset.

22. In addition, we recommend specifying in the revised ED that the assessment should be performed for each lease component (for example, land and building) separately.

23. This guidance is the same as the guidance to be used when classifying leases of property according to the revised proposals, and is similar to the guidance an entity uses today when classifying leases as finance/capital or operating leases in accordance with IAS 17 *Leases* and Topic 840 *Leases* in the *FASB Accounting Standards Codification*®. We think that including guidance that is familiar to constituents and is consistent with other parts of the revised ED will make the principle of control described in paragraph 20 above easier to apply within the context of sale and leaseback transactions and, consequently, lead to more consistent application.

Sale and leaseback transactions that include a call option with an exercise price below the original selling price of the asset

24. Sale and leaseback transactions, particularly those that relate to equipment leases, can include a call/purchase option giving the seller/lessee the unconditional right to repurchase the asset for less than the original selling price of the asset. That price is not necessarily a bargain price.

25. If the arrangement includes a call option, then the seller/lessee would conclude that a sale has not occurred. Paragraph B40 of the 2011 Revenue ED would require the seller/lessee to account for the contract as a lease if the exercise price

of the call option is below the original selling price of the underlying asset, and as a financing arrangement if the exercise price of the call option is equal to or more than the original selling price of the underlying asset (paragraph B40 of the 2011 Revenue ED is included in the appendix to this paper). If strictly applied within the context of a sale and leaseback transaction, these words would imply that the entity should account for the overall transaction as a lease and leaseback when the strike price of the call option is below the original selling price.

26. However, we do not recommend this approach. Instead, we recommend that when an entity concludes that a sale has not occurred according to the revenue recognition proposals, the entire transaction should be accounted for as a financing arrangement. We think our recommendation reflects the boards' previous tentative decisions regarding sale and leaseback transactions. But more importantly, we do not think lease and leaseback accounting would provide useful information to users of financial statements and, consequently, the cost of applying lease and leaseback accounting in this situation would outweigh the benefits.

27. For the buyer/lessor, the outcome of accounting for the transaction as a lease and leaseback would be similar to accounting for it as a financing arrangement. Consequently, accounting for the transaction as a lease and leaseback, rather than as a financing arrangement, would only affect the accounting applied by the seller/lessee. Lease and leaseback accounting could result in the seller/lessee recognising a gain relating to the portion of the asset that it will consume during the leaseback, if the seller/lessee has measured the asset that is the subject of the transaction on a cost basis. Not only is that somewhat difficult to understand, but lease and leaseback accounting in this situation is also likely to be complicated to apply. In addition, if the asset that is the subject of the transaction is property, the ultimate lessee could be forced to recognise a right-of-use asset relating to an underlying asset that would also be recognised on its balance sheet. Such accounting would be very difficult to understand and explain and would not, in our view, provide useful information to users of financial statements.

28. If the boards agree with this conclusion, some minor amendments may need to be made to paragraph B40(a) of the 2011 Revenue ED when preparing the final Standard. We would propose that those amendments should clarify that an entity would account for the contract as a financing arrangement in the situation described in paragraph B40(a) if the overall transaction were a sale and leaseback transaction.

Staff recommendations

29. We recommend clarifying the following in the revised *Leases* ED:

    (a) When determining whether a sale has occurred in a sale and leaseback transaction, an entity should apply the guidance developed in the Revenue recognition project to the entire transaction.

    (b) The existence of the leaseback does not, in isolation, prevent the transaction from being accounted for as a sale and a leaseback.

    (c) However, if the leaseback is such that the seller/lessee has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset, a sale has not occurred. For the purposes of a sale and leaseback transaction, the seller/lessee is assumed to have the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset if:

        (i) the lease term is for the major part of the economic life of the underlying asset; or

        (ii) the present value of the minimum lease payments accounts for substantially all of the fair value of the underlying asset.

        If there are multiple lease components in the transaction, the assessment is performed for each lease component separately.

    (d) If an entity concludes that a sale has not occurred in accordance with the revenue recognition guidance, the entire transaction is accounted for as a financing arrangement.

30. We also recommend some minor amendments to the wording of paragraph B40(a) of the 2011 Revenue ED. Those amendments would clarify that if an entity has an unconditional obligation or unconditional right to repurchase the asset, the entity should account for the contract as a lease in accordance with the leases standard, if the entity can repurchase the asset for an amount that is less than the original selling price of the asset, unless the contract is part of a sale and leaseback transaction. In that case, the entity should account for the contract as a financing arrangement.

Question for the boards—sale and leaseback transactions
Do the boards agree with the staff recommendations in paragraphs 29 and 30 of the paper?

APPENDIX—Extract from the 2011 Revenue ED

Application guidance on repurchase agreements

B40 If an entity has an unconditional obligation or unconditional right to repurchase the asset (a forward or a call option), the customer does not obtain control of the asset because the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset (even though the customer may have physical possession of the asset). Consequently, the entity shall account for the contract as either of the following:

(a) a lease in accordance with IAS 17 *Leases*, if the entity can repurchase the asset for an amount that is less than the original selling price of the asset; or

(b) a financing arrangement in accordance with paragraph B42, if the entity can repurchase the asset for an amount that is equal to or more than the original selling price of the asset.