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Project	**Revenue Recognition**		
Paper topic	Repurchase Agreements		
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Purpose

1. This paper considers possible clarifications to the proposed accounting for repurchase agreements in paragraphs IG38—IG48/B38—B48 of the November 2011 Exposure Draft, *Revenue from Contracts with Customers* ('2011 ED').

Staff recommendation

2. The staff recommend the following for repurchase agreements:

   (a) When a put option (with an exercise price less than the original sales price) is included in a sale-leaseback transaction, and the holder has a significant economic incentive to exercise the put option, the contract should be accounted for as a financing transaction.

   (b) The implementation guidance for repurchase agreements should not specify that it applies only to *unconditional* forwards, call options and put options.

   (c) Clarify that processing costs should be excluded from the repurchase price when an entity sells a product to a contract manufacturer and repurchases the product as part of a larger component for a higher price.

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(d) No changes to the 2011 ED regarding feedback received on some application questions (formerly EITF 95-1 and EITF 95-4) as described in paragraphs 15-27 of this paper.

(e) Amend the implementation guidance for call options to include an assessment of whether the entity has a significant economic incentive *not* to exercise the option.

Structure of the paper

3. The remainder of this paper is organized into the following sections:

   (a) Background (paragraphs 4-5);

   (b) Proposed requirements in the 2011 ED (paragraphs 6-10);

   (c) Tentative decisions reached in leases (paragraphs 11-13);

   (d) Other Amendments (paragraphs 14-0);

   (e) Application Questions (paragraphs 16-24);

   (f) Call Options—significant economic incentive not to exercise (paragraphs 25-33);

   (g) Appendix A – Summary of proposed changes; and

   (h) Appendix B – Summary table of accounting for repurchase agreements.

Background

4. Paragraph IG38/B38 of the Implementation Guidance explains that "a repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component." Paragraph B39/IG39 further explains that repurchase agreements come in three forms: (a) a forward, (b) a call option, and (c) a put option.

5. The objective of the implementation guidance is to help entities determine how the existence of a repurchase agreement affects the customer's ability to control (ie direct the use of and obtain substantially all the remaining benefits of) the asset.

Proposed requirements in the 2011 ED (IG38-IG50)

A forward or call option

6. When a forward or call option exists in a repurchase agreeement (ie an entity's unconditional obligation or unconditional right to repurchase the asset), paragraph IG40/B40 explains the application of the control principle as follows:

> 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 should account for the contract as either of the following:
>
> (a) A lease in accordance with Topic 840/IAS 17 *Leases*, if the entity can repurchase the asset for an amount that is less than the original selling price of the asset
>
> (b) A financing arrangement in accordance with paragraph IG42/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.

A put option

7. When a put option exists in a repurchase agreement (ie an entity's unconditional obligation to repurchase the asset at the customer's request), paragraph IG43/B43 explains the application of the control principle as follows:

> If an entity has an unconditional obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether a customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Hence, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 840/IAS 17.

8. Paragraph IG44/B44 provides guidance to determine whether a customer has a significant economic incentive to exercise its right as follows: "an entity should consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of repurchase and the amount of time until the right expires. If the repurchase price is expected to significantly exceed the market value of the asset, the customer has an economic incentive to exercise the put option."

9. When the customer does not have a significant economic incentive to exercise its right, paragraph IG45/B45 indicates that "the entity should account for the agreement similar to the sale of a product with a right of return as discussed in paragraphs IG2–IG9."

10. In other cases, when the repurchase price of the asset exceeds the original selling price and is more than the expected market value of the asset, it is not necessary to consider whether the customer has economic incentive to exercise the option and an entity would account for the contract as a financing arrangement.

Tentative decision reached in leases

11. Because of the close interaction with the leases project and the implementation guidance on repurchase agreements in the 2011 ED, the staff observed that in the

September 20, 2012 joint meeting on leases, the Boards discussed how a sale-leaseback may affect an entity's analysis of a repurchase agreement. At that meeting, the Boards tentatively confirmed that if there is a call option (with a strike price less than the original sales price) included in the transaction that also includes terms evaluated for a potential sale and subsequent leaseback, then the sale and leaseback should be accounted for as a financing.

12. As a result of the tentative decision, IG40 of the 2011 ED will be amended to clarify (with the words underlined) that if an entity has an unconditional obligation or unconditional right to repurchase the asset for an amount that is less than the original selling price of the asset (ie a call option), the entity should account for the contract as a lease in accordance with the leases standard, 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.

13. At that meeting, one Board member requested the staff to also consider the guidance on put options and how it may be affected by a sale-leaseback transaction. The staff think that, consistent with the Board's tentative decisions related to a call option, when there is a put option (with a repurchase price less than the original sales price) in a sale-leaseback transaction, and the customer (lessor) has a significant economic incentive to exercise the put, then the contract should be accounted for as a financing.

Question 1– Put option included in sale-leaseback transaction
Do the Boards agree with the staff's analysis that a put option (with a repurchase price less than the original sales price) is included in a sale-leaseback transaction, and the customer (lessor) has a significant economic incentive to exercise the put, then the contract should be accounted for as a financing?

Summary of feedback and staff analysis

Other Amendments

14. The Boards did not ask a question about repurchase agreements in the 2011 ED, but nonetheless several respondents commented on the proposals. The staff think that some of the comments can be addressed as follows:

    (a) **Use of the term 'unconditional' (paragraph IG39/B39)** – The staff do not think that the Boards intended to exclude repurchase agreements that may include conditions. The staff think the word *unconditional* was included to indicate that the customer could be unconditionally forced to sell the asset back to the entity, which would exist in any repurchase agreement. As a result, the staff think the word *unconditional* should be removed.

    (b) **Exclusion of processing costs in product financing arrangements** – Some questioned whether processing costs should be included in the determination of the repurchase price when an entity sells a product to a contract manufacturer and repurchases the product as part of a larger component for a higher price. The staff think that it was not the Boards' intent to include the processing costs in the determination of the repurchase price and therefore will specify they should be excluded.

Question 2– Other amendments

Do the Boards agree with the staff's analysis that the following amendments should be made to the revenue proposals:

a) Delete *unconditional* from the repurchase agreements implementation guidance, and

b) Clarify that processing costs should be excluded from the repurchase price when an entity sells a product to a contract manufacturer and repurchases the product as part of a larger component for a higher price?

15. Other issues raised by respondents include:

    (a) Application questions, which arise from the proposed withdrawal of two EITF issues (paragraphs 15-23), and

    (b) Whether call options should preclude revenue recognition when the entity has significant economic incentive not to exercise the option (paragraphs 24-34).

Application Questions

16. Some respondents raised questions regarding the application of the implementation guidance to some common fact patterns including:

    (a) a contract that includes a guaranteed minimum resale value, and

    (b) equipment that is sold and subsequently repurchased subject to an operating lease.

17. The staff think that these questions arose because the fact patterns are discussed in two separate EITF issues that will be rescinded as part of the codification amendments.

Guaranteed Minimum Resale Value

18. Many respondents from the automotive industry commented that they routinely enter into fleet agreements with rental car companies whereby they agree to either repurchase such vehicles after a specified period of time or guarantee the residual value of the vehicle at the customer's option. In the former scenario the automaker reclaims ownership of the vehicle and then sells it at auction, whereas in the latter scenario the rental car company maintains custody and remarkets the vehicle but is entitled to a minimum resale value. These respondents interpret that the 2011 ED would require that the agreement to repurchase the car be accounted for as a lease (if the customer has significant economic incentive to exercise its right, as per paragraph IG43/B43), whereas the agreement to guarantee the residual value would be accounted for as a sale (ie because the guaranteed residual value does not appear to affect the customer's ability to direct the use of

and obtain substantially all of the benefits from the asset). In addition, to being different than existing US GAAP (ASC 605-50, *Revenue Recognition–Customer Payments and Incentives*, formerly EITF 95-1), where both transactions are accounted for as a lease, these respondents expressed concerns about the different outcomes under the revenue proposals. They explained that they thought that the only economic difference between the two transactions is the timing of cash flows.

> Subject to completion of the Boards project on leasing, we believe the Revised ASU may result in two economically similar transactions being accounted for in a different manner and/or provide structuring opportunities that may lead to different accounting for economically similar transactions. (CL#201 General Motors Company)

19. The staff observe that the agreement to repurchase the car would represent a put option for which the customer has a significant economic incentive to exercise. In accordance with the 2011 ED, this put option should be accounted for as a lease (with a purchase option). As explained in paragraph BC323, this is because "if the customer has an unconditional right to require the entity to repurchase the asset at a price that is lower than the original sales price and the customer has a significant economic incentive to exercise that right, then the customer would not obtain control of the asset. In those cases, the Boards decided that the existence of the option effectively constrains the ability of the customer to direct the use of and obtain substantially all the remaining benefits from the asset. Although the customer is not obliged to exercise its put option, the fact that it has a significant economic incentive to exercise that right means that it would likely incur a loss if it did not do so (for example, the repurchase price may be set significantly above the expected market value of the asset at the date of the repurchase)."

20. However, in other cases, when an entity guarantees the residual value, the customer is not encumbered in its ability to utilize the asset or enjoy substantially all the remaining benefits from the asset. In addition, in these cases the customer could choose to keep the asset, thus maintaining legal title and physical possession, or should the customer decide to sell the asset, the customer would be

entitled to any sales proceeds in excess of the guaranteed amount if they were able to sell the asset for a higher amount. In the staff's view, this is quite different to the economics of the repurchase agreement where, if the customer exercised the put option, the amount of consideration received by the customer would be fixed. Given this difference in the economics, the staff think that the different accounting that results from applying the 2011 ED would be appropriate. That is that the put option would be accounted for as a lease, as per paragraph IG43/B43, and the guaranteed residual value would be accounted for as a sale with a guarantee (as a separate performance obligation). Furthermore, that guarantee would be accounted for and measured in accordance with Topic 460, *Guarantees* and IFRS 9 *Financial Instruments* or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Equipment sold and subsequently repurchased subject to an operating lease

21. Respondents from the automotive industry also questioned the effect of removing existing guidance on equipment sold and subsequently repurchased subject to an operating lease. This often occurs when auto manufacturers sell automobiles to dealerships and subsequently, the dealer's customer chooses to lease the automobile through the manufacturer's captive finance affiliate (the dealer's customer generally has alternative financing options). In these cases, the manufacturer repurchases the product from the dealer, subject to a lease with the dealer's customer. Subtopic 605-15, *Revenue Recognition – Products* (formerly EITF 95-4) requires these transactions to be accounted for as a sale by the auto manufacturers when specific criteria are met (ie the dealer is independent, control of the automobile transfers to the dealer, a lease obligation does not exist at the time of the sale, and the customer has other financing alternatives).

22. Some respondents questioned whether these transactions really represent a put option, and whether they would be required to apply the guidance on repurchase agreements as follows:

> In this example, the dealer may be deemed to have a put option as addressed beginning in Paragraph IG38 of the Exposure Draft requiring the manufacturer (via its finance affiliate) to repurchase the product for lease to the dealer's customer. It is not clear to us whether the manufacturer's sale transaction would thus be deemed a sale with a right of return which would result in a deferral of revenue. We believe the guidance under ASC 605-15-25-5 appropriately addresses the substance in this example and control has transferred. We do not believe it was the Board's intent to change existing practice for such transactions. We suggest that the guidance in the Exposure Draft be clarified in this respect. (CL#144 Navistar)

23. In the staff's view, the transaction described above does not meet the definition of a repurchase agreement in paragraph IG38/B38. This is because the sale and subsequent agreement to repurchase the car represent two separate transactions with different customers. That is, a sale to the dealership (the entity's customer) and a lease with the lessee of the entity. In addition, the staff do not think that the fact that an entity (auto manufacturer) subsequently could be asked to repurchase the asset to facilitate a separate leasing transaction from an acceptable lessee, would preclude the customer (auto dealership) from obtaining control of the asset. The possibility of providing lease financing at market terms does not preclude the dealership from directing the use of or obtaining substantially all of the remaining benefits from the asset.

Staff recommendation

24. Based on our analysis of both of the application issues described above, the staff think that the 2011 ED provides sufficient guidance to enable an entity to assess when control transfers in the examples provided. In addition, the staff think that the accounting outcome from applying the 2011 ED and the implementation guidance for repurchase agreements to these arrangements is appropriate. Therefore, the staff do not recommend any changes to the 2011 ED.

Question 3– Application questions
Do the Boards agree with the staff's analysis that no changes to the revenue proposals are necessary for: (a) Guaranteed minimum resale value, and (b) Equipment sold and subsequently repurchased subject to an operating lease?

Call options – significant economic incentive not to exercise

25. Some respondents questioned why the existence of a call option – regardless of how likely the holder is to exercise – would always preclude the transfer of control (paragraph IG40/B40), whereas a put option requires an analysis of whether the customer has a significant economic incentive to exercise (paragraph IG43/B43). These respondents explained that without including an analysis of whether the holder has a significant economic incentive to exercise the option, an entity may structure its options to achieve revenue in specific periods. Consider the following examples:

Example 1 – short life
An entity sells specialized equipment at the end of June. The customer has physical possession. However, the sale agreement included a call option that expires on July 1 (three days after the initial sale) with a repurchase price equal to the original sales price. The entity no longer has a need for the equipment and therefore does not have significant economic incentive to exercise the call option.

26. In this example, even though the entity does not have significant economic incentive to exercise the call option, the inclusion of the of the call option in the sales agreement means that the initial transfer is accounted for as a financing arrangement (in accordance with paragraph IG40(b)/B40(b). Furthermore, no revenue would be recognized at the time of transfer of the equipment on June 30

and instead, revenue would be recognized in the following period upon expiration of the call option.

> **Example 2 – Repurchase price greater than expected market value**
>
> An entity sells equipment that is no longer needed as part of its operations. The sale agreement includes a call option with a repurchase price that is 25% higher than the original sales price that can be exercised at any time and expires in two years. The equipment typically depreciates at a rate of 15% per year and is not specialised. Therefore, the entity has a significant economic incentive *not* to exercise the call option, because the repurchase price is greater than the expected market value.

27. The staff think that such arrangements would not be common and parties would not likely include such a provision in the arrangement. However, the staff observe that without the requirement of whether to assess whether the entity has a significant economic incentive to exercise the call option, the mere presence of the call option would change the accounting for the sale of the equipment. This is because the guidance in paragraphs IG40/B40 indicates that the presence of the call option means that the customer does not control the asset. However in example 2, the fact that the call option is unlikely to be exercised, would not preclude the customer from controlling the asset because it is unlikely to be exercised.

28. As mentioned above, the reason for precluding sale accounting when the arrangement includes a call option is that exercise is outside of the customer's control. BC318 states that the customer is constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset. Because the customer is obliged to return, or to stand ready to return, the asset to the entity, the customer cannot use up or consume the entire asset. Moreover, the customer cannot sell the asset to another party (unless that sale is subject to a repurchase agreement, in which case the customer's benefit from the sale is constrained).

29. Despite the entity's stated intentions at the inception of the arrangement, the fact remains that the entity has the right to exercise the option. Facts and circumstances could change that compel the entity to exercise the call option.

Because of this possibility, the customer will always be restricted in its ability to control the asset.

30. However, in the staff's view, the implementation guidance was not intended to apply to nonsubstantive options and furthermore, the staff does not think that a nonsubstantive option should affect the entity's assessment of the transfer of control to a customer. The staff believe that such nonsubstantive terms should generally be ignored. However, if the final standard does not expressly state this, it could be subject to abuse. The staff considered Topic 480, *Distinguishing Liabilities from Equity* (formerly FAS 150) which addresses such nonsubstantive features as follows:

> In applying ASC Topic 480, that objective shall not be circumvented by nonsubstantive or minimal features included in instruments. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions…Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

31. The staff think that the Boards could address this concern by including, similar to that for put options, an assessment of whether there is economic incentive to exercise (or not exercise) the call option. This is because the staff think the presumption in the 2011 ED that control does not transfer when the entity has a right to repurchase the asset could be overcome if the entity had a significant economic incentive ***not*** to exercise the option.

32. If the Boards decide to amend the guidance for call options, paragraph IG40 of the revenue proposals could be amended as follows:

> 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), unless the entity has significant economic incentive *not* to exercise the option.

Staff recommendation

33. The staff recommend the Boards amend the implementation guidance for repurchase agreements, such that when there is a call option, an entity would be required to assess whether it has a significant economic incentive *not* to exercise the option. In these cases, the staff think that the presence of a call option that will likely not be exercised should not preclude an entity from recognising revenue at the time its performance obligation is satisfied. The staff observe that this change will mitigate an entity's ability to structure transactions to preclude or delay revenue recognition when an option is nonsubstantive.

Question 4– Call options

Do the Boards agree with the staff's recommendation to amend the implementation guidance for repurchase agreements, such that when there is a call option, an entity would be required to assess whether it has a significant economic incentive *not* to exercise the option?

Appendix A

A1. The following table lists the proposed requirements from the 2011 Exposure Draft that relate to accounting for repurchase agreements and identifies which of those proposals might change as a result of the staff recommendations in this paper.

Proposals from the 2011 Exposure Draft	**Anticipated change?**
Repurchase agreements (see paragraph 37)	
IG38 A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.	No material change is anticipated.
IG39 Repurchase agreements generally come in three 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) c. An entity's unconditional obligation to repurchase the asset at the customer's request (a put option).	Staff recommend deleting the word 'unconditional' – refer to paragraph 14(a) of this paper.
A forward or call option	
IG40 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 should account for the contract as either of the following: (a) A lease in accordance with Topic 840, if the entity can repurchase the asset for an amount that is less than the original selling price of the asset. (b) A financing arrangement in accordance with paragraph IG42, if the entity can repurchase the asset for an amount that is equal to or more than the original selling price of the asset.	Staff recommend including an assessment in a call option of whether an entity has a significant economic incentive not to exercise – refer to paragraph 34 of this paper. Staff recommend accounting for the sale-leaseback as a financing arrangement in the

	presence of a call option – refer to paragraph 12 of this paper.
IG41 When comparing the repurchase price with the selling price, an entity should consider the effects of the time value of money.	No material change is anticipated.
IG42 If the repurchase agreement is a financing arrangement, the entity should continue to recognize the asset and also recognize a financial liability for any consideration received from the customer. The entity should recognize the difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer as interest and, if applicable, holding costs (for example, insurance). If the option lapses unexercised, an entity should derecognize the liability and recognize revenue.	Staff recommend accounting for the amount of consideration to be paid to the customer, <u>excluding processing costs</u>, as interest—refer to paragraph 14(b) of this paper.
A put option	
IG43 If an entity has an unconditional obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether a customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Hence, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 840.	Staff recommend accounting for the sale-leaseback as a financing arrangement in the presence of a put option where the holder has a significant economic incentive to exercise – refer to paragraph 13 of this paper.
IG44 To determine whether a customer has a significant economic incentive to exercise its right, an entity should consider various factors, including the relationship of the repurchase price to the expected market value of the asset at the date of repurchase and the amount of time until the right expires. If the repurchase price is expected to significantly exceed the market value of the asset,	No material change is anticipated.

the customer has an economic incentive to exercise the put option.	
IG45 If the customer does not have a significant economic incentive to exercise its right, the entity should account for the agreement similar to the sale of a product with a right of return as discussed in paragraphs IG2–IG9.	No material change is anticipated.
IG46 If the repurchase price of the asset exceeds the original selling price and is more than the expected market value of the asset, the contract is in effect a financing arrangement. Hence, an entity should: (a) Continue to recognize the asset. (b) Recognize a liability that initially should be measured at the amount of the original selling price of the asset.	No material change is anticipated.
IG47 When comparing the repurchase price with the selling price, an entity should consider the effects of the time value of money.	No material change is anticipated.
IG48 If the option lapses unexercised, an entity should derecognize the liability and recognize revenue.	No material change is anticipated.

Appendix B

B1. The following table summarizes the accounting for repurchase agreements in IG38—IG48/B38—B48:

	Repurchase price (RP) : original sales price (SP)	**Significant economic incentive to exercise**	**Accounting**
Call option/forward	RP ***is less than*** SP	N/A	Lease, Topic 840/IAS 17
Call option/forward	RP is greater than or equal to SP	N/A	Financing, IG42/B42
Put option	RP is less than SP	Yes	Lease, Topic 840/IAS 17
Put option	RP is less than SP	No	Right of return, IG2—IG9/B2—B9
Put option	RP is greater than SP and expected market value	N/A	Financing, IG42/B42