STAFF PAPER

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Project	**Leases**		
Paper topic	Sale and Leaseback Transactions		
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Introduction

1. The purpose of this paper is to discuss various issues with respect to the accounting for sale and leaseback transactions.
2. This paper is structured as follows:
   (a) Summary of Staff Recommendations
   (b) Background
   (c) Summary of Proposals in the 2013 ED
   (d) Summary of Feedback Received on the 2013 ED
   (e) Staff Analysis
      (i) Determining whether a sale has occurred
      (ii) Accounting for the sale/purchase
      (iii) Accounting for the leaseback
      (iv) Accounting for "off-market" terms
      (v) Accounting for "failed" sale and leaseback transactions
      (vi) Accounting for sale and leaseback transactions during transition
   (f) Appendix A – Proposed Changes to the 2013 ED

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Summary of Staff Recommendations

3. In summary, the staff are recommending the following in this paper:

   (a) The Boards reaffirm that in order for a sale to occur in the context of a sale and leaseback transaction, the sale must meet the requirements for a sale in the new revenue recognition standard. In addition, the Boards clarify application of the revenue recognition guidance to sale and leaseback transactions by:

      (i) Reaffirming that the presence of the leaseback does not preclude the seller-lessee from concluding that it has sold the underlying asset to the buyer-lessor.

      (ii) Stipulating that, under U.S. GAAP, a sale does not occur if the leaseback is a Type A lease. This would be assessed from the perspective of the lessee, based on the classification criteria applicable to lessees. A sale does not occur in these circumstances because, under the FASB's lessee model, the seller-lessee would, in effect, be immediately repurchasing the asset (similar guidance would not be included in the final IFRS standard).

      (iii) Clarifying that if the seller-lessee has a repurchase option, the buyer-lessor would not obtain control of that asset, and therefore a sale has not occurred. Consistent with the discussion in the Basis for Conclusions to the new revenue recognition standard, the repurchase option should be ignored if it is nonsubstantive.

   (b) Some staff members recommend that the Boards include additional application guidance about how to apply the control guidance in the new revenue recognition standard to a sale and leaseback transaction, of the nature described in the staff analysis above. Other staff members do not think additional application guidance should be provided.

(c) Some staff members think the Boards should reaffirm the proposal in the 2013 ED that any gain or loss on a completed sale in a sale and leaseback transaction be accounted for consistently with the guidance that would apply to any other equivalent sale (that is, without the presence of the leaseback). Other staff members recommend that, for IFRS seller-lessees, the recognition of any gain on a completed sale be restricted to the amount of the gain that relates to the residual asset (that is, in a sale and leaseback transaction, the seller-lessee has retained the right to use the underlying asset and has therefore, in effect, sold its interest in the residual asset, rather than the entire underlying asset).

(d) The Boards reaffirm that, if a sale is completed, the leaseback is accounted for in the same manner as any other lease by the seller-lessee and the buyer-lessor.

(e) With respect to sale and leaseback transactions entered into at "off-market" terms, an entity:

    (i) Determine any potential "off-market" adjustment based on the difference between the sale price and the fair value of the underlying asset *or* the difference between the present value of the contractual lease payments and the present value of fair market value lease payments, whichever provides more readily determinable evidence.

    (ii) Account for a *deficiency* of the sale price or the contractual leaseback payments as compared to the fair value of the underlying asset or the fair market lease payments, respectively, in the same manner as a prepayment of rent.

    (iii) Account for an *excess* of the sale price or the contractual leaseback payments as compared to the fair value of the underlying asset or the fair market lease payments, respectively, as additional financing from the buyer-lessor to the seller-lessee.

(f) The Boards reaffirm that a "failed" sale-leaseback transaction should be accounted for as a financing transaction by both parties to the transaction.

(g) With respect to transition for sale and leaseback transactions, the Boards reaffirm the sale and leaseback transition proposals in the 2013 ED, other than as follows:

   (i) Entities should not reassess whether a transaction previously accounted for as a sale and leaseback would have qualified as a sale (or purchase) in accordance with the new revenue recognition standard. Instead, entities should reassess only those transactions that still constitute "failed sales" at the effective date.

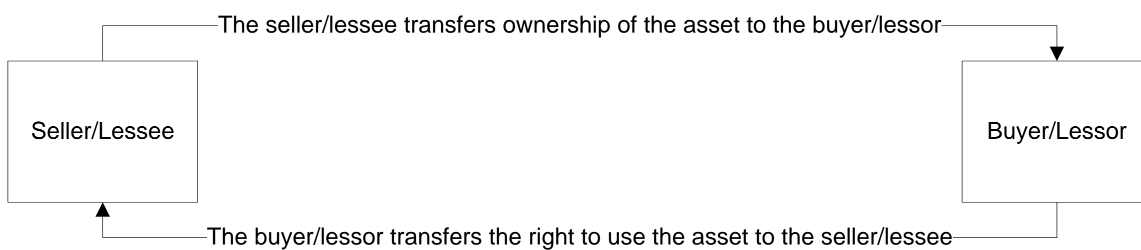
   (ii) Any seller-lessee deferred gains or losses that resulted from "off-market" sales and leaseback terms should be recognized as an adjustment to the leaseback ROU asset (if a deferred loss) or accounted for as a remaining financial liability (if a deferred gain) at the beginning of the earliest period presented.

   (iii) To the extent the Boards decide to recognize the gain on a completed sale in a sale and leaseback transaction only to the extent of the portion related to the residual asset, the staff propose that entities apply this approach prospectively from the effective date of the final leases standard, otherwise applying the sale and leaseback transition proposals as described in this paper.

Background

General

4. In a sale and leaseback transaction, one entity (the seller-lessee) sells an asset it owns to another party (the buyer-lessor) and then, simultaneously, leases back all, or a portion, of the same asset.



5. Sale and leaseback transactions currently occur in a number of scenarios:
   (a) To obtain financing;
      (i) to generate cash flows; or
      (ii) to obtain a particular accounting outcome (popularly known as off-balance sheet accounting).
   (b) To accommodate for a physical transition or relocation (that is, the seller-lessee may be moving to new premises, but is leasing the old premises for a few years in transition).
   (c) To reduce exposure to the risks of owning an asset.

6. Under existing U.S. GAAP (Topic 840 - *Leases*) and IFRS (IAS 17 *Leases*), a lease can be classified as either a capital/finance lease, which is capitalized on the balance sheet, or an operating lease, which is **not** capitalized on the balance sheet. For purposes of determining the accounting for the leaseback component of sale and leaseback transactions, these same classification tests apply to determine whether the leaseback is a capital/finance lease or an operating lease.

7. The seller-lessee in a sale and leaseback transaction may "realize" profit or loss on the sale (as a result of a difference between the carrying amount of the asset on their balance sheet at the time of the sale and the agreed-upon selling price of the asset with the buyer). However, recognition of any profit or loss depends on the facts and circumstances of the given sale and leaseback transaction.

Existing U.S. GAAP (Topic 840)

8. Under Topic 840, sale and leaseback accounting is affected by the nature of the underlying asset as real estate or other-than-real estate. Sale and leaseback transactions with an underlying real estate asset are generally complex because of complicated U.S. GAAP rules for sales of real estate (Subtopic 360-20). The staff note that the codification amendments resulting from ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, retain these complexities for sales of real estate in the context of a sale and leaseback transaction (that is, the consequential amendments to the codification in ASU 2014-09 retained the provisions of legacy FAS 98, *Accounting for Leases*).

9. For sale and leaseback transactions involving assets that are not real estate, a sale of the underlying asset is presumed to occur. Recognition of any gain on the sale of the underlying asset depends on the rights retained by the seller-lessee. The following table shows the thresholds used under existing U.S. GAAP:

Rights Retained by the Seller/Lessee

Minor	More than minor, but less than substantially all	Substantially all

0% **10%** **90%** **100%**

10. Tests roughly equivalent to, or inverse to, the 75% and 90% tests used for lease classification are used as guidelines to distinguish between minor leasebacks, more-than-minor leasebacks, and leasebacks that allow the seller-lessee to retain substantially all the remaining rights to the underlying asset.

11. The treatment of any gains or losses realized by a seller-lessee under existing U.S. GAAP can be summarized as follows:

    (a) For transactions resulting in a realized loss by the seller-lessee, recognize the loss immediately when the fair value of the asset at the time of the sale and leaseback is less than the asset's book value. When the fair value of the underlying asset *exceeds* its book value, the loss is accounted for as a prepayment of rent.

    (b) For transactions resulting in a gain by the seller-lessee:

        (i) recognize the gain immediately when the seller-lessee retains only a minor portion of the right to the remaining use of the asset sold. When sale and leaseback transactions are not conducted "at-market," the gain or loss is effectively adjusted to reflect fair value.

        (ii) recognize a gain to the extent that the profit on the sale exceeds either the present value of the minimum lease payments (for operating leasebacks) or the carrying amount of the underlying asset on the date of the sale (for capital leasebacks) when the seller-lessee retains more than a minor part, but less than substantially all of the remaining use of the asset sold.

        (iii) defer and amortize any profit when the seller-lessee retains substantially all the risks and benefits incidental to the ownership of the underlying asset.

Existing IFRS (IAS 17)

12. Under IAS 17 the recognition of any profits or losses by the seller-lessee is determined by the classification of the leaseback as a finance lease or an operating lease. In summary:

(a) For sale and leaseback transactions resulting in an operating lease, a seller-lessee generally recognizes any gain or loss on the sale of the underlying asset.

(b) For sale and leaseback transactions resulting in a finance lease, a seller-lessee does not recognize any excess of sales proceeds over the carrying amount as income at contract inception. Instead any gain is deferred and amortized over the lease term.

(c) When sale and leaseback transactions are not conducted "at-market," the gain or loss is effectively adjusted to reflect fair value.

Summary of Proposals in the 2013 ED

13. The revised exposure draft on leases issued in May 2013 (2013 ED) included proposals to align the accounting for sale and leaseback transactions under U.S. GAAP and IFRS.

14. The 2013 ED proposed that an entity would account for a sale and leaseback transaction as a sale of the underlying asset and a leaseback of that underlying asset only if that transaction qualifies as a sale in accordance with the new revenue recognition standard (that is, if the buyer-lessor obtains control of the underlying asset). If the transaction does not qualify as a sale, an entity would account for the entire transaction as a financing transaction.

15. The 2013 ED also clarified that the existence of the leaseback does not, by itself, prevent the transaction from being accounted for as a sale and a leaseback.

16. The 2013 ED further notes that if the seller-lessee has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the underlying asset, a sale has not occurred (that is, the buyer-lessor does not obtain control of the asset). The 2013 ED stipulated that this would be the case if either of the following conditions (the "override conditions") is met:

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

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

17. In addition, before the issuance of the 2013 ED as part of their joint revenue recognition project, the Boards clarified that, if a sale and leaseback arrangement includes a call option (that is, a purchase option) at any exercise price or a forward (that is, a *requirement* to repurchase the underlying asset), the seller-lessee should account for the contract as a financing arrangement and not as a sale and leaseback. This is because the buyer-lessor would not obtain control of the underlying asset.

Summary of Feedback Received on the 2013 ED

Support

18. There is broad support among those constituents who provided feedback to align the accounting for the sale in a sale and leaseback transaction with the new revenue recognition standard. Those constituents, however, note some potential application issues as discussed below.

> Consistent with our remark that we see no conceptual reason that a sale and leaseback should be treated differently than a normal sale and a normal lease transaction, we support that the revised proposals require entities to assess whether the transferred asset has been sold using revenue recognition control principles rather than on the basis of a list of conditions that would apply only when assessing sale and leaseback transactions. – *CL#433, Large Preparer*

Concerns

19. Constituents that commented on the 2013 ED sale and leaseback proposals generally had concerns in one or more of the following areas:
    (a) Determining whether there is a sale;
    (b) Accounting for any gain on the sale;
    (c) Accounting for "off-market" terms ; and
    (d) Accounting for existing sale and leaseback transactions during transition.

Determining whether there is a sale

20. Most constituents either expressed support for aligning the determination of a sale in a sale and leaseback transaction with the new revenue recognition guidance or did not comment on this proposal. However, some constituents expressed the view that this proposal would disconnect U.S. GAAP accounting from the U.S. tax and legal requirements, principally with respect to purchase (or repurchase) options. This is because the new revenue recognition guidance precludes sale accounting by the seller when there is a repurchase option in the contract. In contrast, U.S. tax and legal requirements generally allow for sale treatment so long as there is not a *bargain* purchase (or repurchase) option. These constituents suggest that the Boards *not* preclude sale accounting for a non-bargain purchase option.

> The decision to have any purchase option at less than the sales price negates sale treatment will create another break in the alignment of GAAP with US tax and legal systems. This will create book/tax differences and the need for additional information to be provided to lenders to give them the information as to what the true nature of the assets and liabilities created by this new approach to sale leaseback accounting. *CL#529, Private Company Preparer*

21. Among those constituents that either explicitly agreed with, or did not disagree with, aligning sale accounting in a sale and leaseback transaction with the new revenue recognition guidance:

(a) Some constituents disagree with the factors included in the 2013 ED that would prevent sale and leaseback accounting (that is, the 2013 ED states that a transfer is not a sale if the lease term of the leaseback is for the major part of the remaining economic life of the underlying asset or the present value of the leaseback payments represents substantially all of the fair value of the underlying asset). Those constituents generally think that these criteria do not align with the transfer of control model in the new revenue recognition guidance, but instead represent a risks and rewards approach.

> [XXXX] also believes it is important to reconcile the guidance on control in the ED to that for sale-leaseback transactions, which appears to consider control based on risks and rewards (e.g., lease term and present value of lease payments). *CL#615, Accountancy Body*

(b) Other constituents recommend that the Boards develop detailed implementation guidance to clarify how to apply the transfer of control criteria in the new revenue recognition standard in the context of a sale and leaseback transaction.

> The criteria in paragraph 112 of the ED noted above are different than the transfer of control criteria under the new revenue recognition guidance. Therefore, we recommend that the Boards develop detailed implementation guidance to clarify the approach to take when considering these criteria. – *CL#199, Accounting Firm*

Accounting for any gain on the sale

22. Some constituents think that recognizing all of the profit associated with the sale of the underlying asset at contract inception would not be reflective of the economics of most sale and leaseback transactions. Some of these constituents suggest that a seller-lessee should recognize the profit over the leaseback term, while others suggest that the amount of profit recognized should be limited (for example, to the portion that is attributable to the residual interest in the asset that the buyer-lessor will obtain at the end of the leaseback).

> Finally, we believe the Board should retain the existing guidance on gain recognition in a sale-leaseback transaction. The terms of sale and leaseback arrangements are usually negotiated as a package. Because of the interdependence of the terms, we believe the Board's rationale for its decision in FASB Statement 13, Accounting for Leases, to require deferral of any gain on the sale continues to be relevant today. - CL#410, *Accountancy Body*

> We are also concerned that the proposed accounting for sale and leasebacks may result in the overstatement of profit. The ED proposes that the determination of whether a sale has occurred should be in accordance with the draft Revenue Recognition standard. In many cases, the seller/lessee has in effect sold the residual interest rather than the whole asset. Immediate recognition of any profit on the sale of the whole asset does not appear to reflect the substance of the transaction. – CL#138, *Large Preparer*

23. A few constituents disagree with the proposals to account for a “failed sale” as a financing transaction. They agree that such a transaction should not result in profit recognition for the seller-lessee. Nonetheless, they think that, if the buyer-lessor retains an interest in the residual asset, it would be more appropriate for the buyer-lessor to account for the transaction in accordance with the lessor proposals, instead

of as a financing transaction. That is because the requirements that apply to financing transactions do not specifically address how a lessor would account for its retained interest in the residual asset. In addition, a few noted that leases often have unique features compared to other financial assets and liabilities and, in their view, it is more appropriate to account for leasebacks within the leases standard, even when a sale has not occurred.

Accounting for "off-market" terms

24. Some constituents have expressed concerns about the proposals on how to account for sale and leaseback transactions for which the sale of the underlying asset is not at fair value or the leaseback payments are not at market rates. These constituents generally think that the determination as to whether the transaction is "off-market" should be based on the fair value of the underlying asset because that will generally be more readily determinable than the fair value of the leaseback payments.

> …the fair value of the asset, not the fair value of rentals, should be used to determine whether a sale is at fair value or not. The fair value of the underlying assets sold is generally available at the time of the transaction or determinable based on established valuation models for which market rents are not the only source of information. The market value of the asset therefore is a better indicator of whether the transaction price is at, above, or below market. – CL#117, *Accounting Firm*

Accounting for existing sale and leaseback transactions during transition

25. Many constituents expressed concern about the transition of existing sale and leaseback transactions. In particular, they expressed concern about:
    (a) Having to reassess previously completed sale and leaseback transactions to determine whether those transactions would have qualified for sale accounting by the seller-lessee under the new revenue recognition guidance;

(b) Accounting for gains previously recognized in a sale and operating leaseback that would no longer meet the sale requirements of the new revenue recognition standard; and

(c) Accounting for any deferred gains at the date of transition. Some constituents have concerns about the proposal to recognize deferred gains as an adjustment to equity at transition. This would result in those gains never being recognized in profit or loss.

26. Many of those constituents recommend grandfathering existing sale and leaseback transactions and applying the proposed guidance for sale and leaseback transactions prospectively.

> We believe that the Proposed ASU's requirement to retrospectively reassess whether or not sale accounting was achieved per the new revenue recognition guidance would be operationally difficult to apply to previously originated sale and leaseback transactions and we do not believe retrospective assessment of sale accounting provides useful financial statement information. – CL#387, *Large Preparer*

Staff Analysis

Determining whether a sale has occurred

27. The staff think that the Boards should reaffirm the principle in the 2013 ED that a seller-lessee should not recognize a sale of the underlying asset unless it meets the requirements for a sale in the new revenue recognition standard (the contract identification, measurement, and recognition provisions of which apply to all sales of nonfinancial assets, including a party that is not a customer). The staff continue to think that it would be inappropriate to have separate sale requirements applicable only to sale and leaseback transactions within the leases guidance. Having a separate set of requirements in the context of a sale and leaseback transaction could

invite structuring opportunities (for example, by entering into a non-substantive leaseback in conjunction with a sale contract in order to circumvent the repurchase agreements guidance in the new revenue recognition standard).

28. Although the staff think preparers should apply the new revenue recognition standard to determine if a sale has occurred, the staff think additional clarifications can be made to assist entities in applying the revenue recognition control principle to sale and leaseback transactions, which would address requests for such information.

<u>Leasebacks that are effectively repurchases of the underlying asset</u>

29. The "override conditions" (defined above in paragraph 16) proposed in the 2013 ED specified when a leaseback would preclude sale accounting by the seller-lessee and were derived from the lease classification test proposed in the 2013 ED. The staff think those criteria are therefore no longer applicable because the Boards have decided not to retain that lease classification test.

30. Instead, the staff think the FASB could clarify that if the leaseback is a Type A lease for the seller-lessee (for U.S. GAAP), no sale has occurred. The FASB have concluded that a Type A lease is effectively a purchase of the underlying asset by the lessee. Consequently, it would be inappropriate for the seller-lessee to account for a concurrent (that is, "round-trip") sale and re-purchase of the same asset.

31. Likewise, although the IASB's lessee accounting model does not have a lease classification test, the staff think the IASB *could* include similar guidance to clarify when a buyer-lessor has not, in effect, purchased the underlying asset because the substance of the transaction is that the seller-lessee is immediately repurchasing all (or substantially all) of the rights to the underlying asset. For example, this guidance could be based on the lessor lease classification test, or the lessor lease classification test excluding the effects of third-party involvement in the leaseback.

Repurchase Options

32. A number of constituents requested that the Boards clarify how the presence of a repurchase option in a sale and leaseback would affect the determination as to whether there was a sale.

> We also believe the Proposed ASU should specifically address the impact of purchase options on the accounting for a sale-leaseback transaction. We believe a purchase option would preclude sale accounting, consistent with the forthcoming Revenue Recognition standard, but believe the FASB should make that clear in the final standard. – *CL#410, Preparer Organization*

33. In response to these comments, the staff think the Boards should clarify that application of the repurchases implementation guidance in the new revenue recognition standard would preclude sale accounting when the entity that would be the seller-lessee has a repurchase option with respect to the underlying asset (as well as when the buyer-lessor has a significant economic incentive to exercise a *put* option). The new revenue recognition standard in the U.S. explicitly states that if a sale contract that is part of a sale-leaseback transaction includes a call (that is, purchase) option or a forward, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction. The IFRS version of the new revenue recognition standard does not state this explicitly; however, this difference in language relates to concerns about *existing* IFRS leases guidance in IAS 17. A customer does not have the ability to obtain substantially all the remaining benefits from an asset if the seller has an option to repurchase that asset (and thereby, at its sole option, *reacquire* the ability to obtain a significant portion of the remaining benefits of the asset).

34. Consistently with the Boards' view in the new revenue recognition standard (as expressed in the Basis for Conclusions—paragraph BC427), the staff think that a nonsubstantive repurchase option would not preclude sale accounting. For example, a purchase option may not be substantive if it is highly improbable that

the entity will exercise that option based on relevant economic factors or the repurchase option entitles the seller-lessee to reacquire only an insignificant portion of the remaining benefits of the underlying asset (for example, if the repurchase option is exercisable only at or near the end of the underlying asset's economic life).

35. The staff think that clarifying that some repurchase options may not be substantive may preclude the possibility of an entity overtly structuring the transaction to manage the timing of gain or loss recognition.

Application of the Revenue Recognition Guidance to Sale and Leaseback Transactions

36. Some constituents have suggested that the transfer of control guidance in the revenue recognition standard does not contemplate the specifics of sale and leaseback transactions. They suggest, therefore, that the Boards should provide additional application guidance in this respect.

37. The staff continue to think that a leaseback, in isolation, does not prevent a seller-lessee from concluding that the buyer-lessor obtains control of the underlying asset (U.S. GAAP) and, thus, that a sale has occurred under the new revenue recognition standard. In the absence of a substantive repurchase option or an in-substance repurchase of the underlying asset as a result of the leaseback, the staff think that a buyer-lessor has obtained both of the following:

    (a) Substantially all the remaining benefits of the underlying asset based on the combination of (i) the cash flows it will receive from the seller-lessee during the leaseback and (ii) the benefits that will be derived from the residual asset; and

    (b) The ability to direct the use of the underlying asset. In practical terms, the staff think a sale and leaseback scenario is not substantively different from that of a financial lessor who purchases an asset from a third-party manufacturer, and immediately conveys the right to control the use of that asset to a lessee, without ever taking physical possession of the

underlying asset. The Boards have previously concluded that subleasing an asset does not mean that a customer does not direct the use of the underlying asset (sublease income is a potential economic benefit a lessee can obtain from its right to use an underlying asset). The staff do not think anyone would suggest that a third-party manufacturer did not complete a sale just because *its* customer (that is, the financial lessor) never took physical possession of the asset, provided the other requirements in the new revenue recognition standard support the conclusion that the customer has obtained control of the asset.

38. The new revenue recognition standard evaluates the transfer of control from the customer's perspective (in this case, the buyer-lessor). Because the sale and the leaseback are considered together as a single arrangement, some hold the view that the buyer-lessor does not obtain the ability to direct the use of the underlying asset until the end of the leaseback term. According to that view, the buyer-lessor would not obtain *control* of the underlying asset until that point in time. This view is premised on the fact that, in most sale and leaseback transactions, the sale of the asset is *contingent* on both parties agreeing to the leaseback (that is, the buyer-lessor must agree to transfer the right to control the use of the asset to the seller-lessee for the period of the leaseback). Some contend that this means the transaction is really a forward sale contract, rather than a sale and leaseback.

39. The staff understand the arguments of those who view a sale and leaseback transaction to be a forward sale. However, the staff do not think the presence of the leaseback is necessarily determinative of the point in time at which the sale occurs. The new revenue recognition standard provides guidance and indicators to help entities determine the point in time at which a customer obtains control of a promised asset. The staff think that the Boards could provide additional application guidance to assist entities in evaluating control in the context of a sale and leaseback transaction. That application guidance might include discussion or an example demonstrating how the control principle and related control indicators in the new revenue recognition standard would be applied to a sale and leaseback transaction. For example, an entity might look to the transfer of control indicators

in the revenue recognition standard to assist in applying the control principle to a sale and leaseback transaction. In a more typical sale and leaseback transaction that includes upfront payment for the underlying asset by the buyer-lessor, an entity might evaluate the control indicators as follows:

(a) *The entity has a present right to payment for the asset* –The agreed sales price for the underlying asset that the buyer-lessor will pay to the seller-lessee is payable upfront.

(b) *The customer has legal title to the asset* – The buyer-lessor obtains legal title to the underlying asset before, or concurrent with, commencement of the leaseback term.

(c) *The entity has transferred physical possession of the asset* –The seller-lessee does not meet this indicator of transfer of control before the end of the leaseback term because it does not relinquish physical possession of the asset until that point in time.

(d) *The customer has the significant risks and rewards of ownership of the asset* – The buyer-lessor typically takes upon itself the same significant risks and rewards of ownership of the underlying asset that any other lessor takes on, including the risks with respect to the residual asset. However, if the seller-lessee retains a significant portion of these risks, such as by providing a residual value guarantee, the buyer-lessor may not have the significant risks and rewards of ownership. If the residual value guarantee is significant enough, the leaseback may be a Type A lease, which would then, as proposed earlier, preclude a sale for U.S. GAAP seller-lessees.

(e) *The customer has accepted the asset* – Customer acceptance may or may not be present in any sale transaction. The absence of formal acceptance terms should not be construed as calling into question whether a sale occurs. Formal acceptance of the underlying asset by the buyer-lessor may support that a sale has occurred, but the staff do not think this indicator would typically be determinative on its own.

40. The seller-lessee in this scenario may conclude that a sale has occurred upfront because it has transferred title to the asset, has a present right to payment for the asset, and the customer has taken on the significant risks and rewards of ownership. However, a seller-lessee *may* not reach the same conclusion if, for example, it provides a significant residual value guarantee because, in that case, the buyer-lessor may not have taken on the significant risks and rewards of ownership. Depending on the facts and circumstances, if the buyer-lessor has not taken on the significant risks and rewards of ownership, the seller-lessee does not have a present right to payment for the asset, and/or the seller-lessee has not relinquished physical possession of the asset (including more than momentarily) it may be inappropriate to conclude that a sale has occurred. The staff acknowledge that in some circumstances, there will be significant judgment involved in determining whether a sale has occurred.

41. Some staff members do not recommend including application guidance applicable to the new revenue recognition standard in the leases guidance. Although the guidance would be written specifically for sale and leaseback transactions, those staff members fear that this could become interpretive guidance more broadly for all revenue contracts. Those staff members think that there could be unintended consequences of including such application guidance in the leases standard—for example, it is possible that the guidance that would be included for sale and leaseback transactions could contradict conclusions that entities and others will reach in the coming months as they evaluate the application of the new revenue recognition standard to all revenue contracts. Those staff think that, by the effective date of the leases standard, entities would have sufficient knowledge of the revenue recognition standard, and the application of its principles, to be able to apply those principles to sale and leaseback transactions appropriately and consistently.

42. In contrast, other staff members think that additional application guidance with respect to this unique class of transaction would help to reduce costs and complexity for preparers by helping them to apply the principle. This would reduce interpretive differences between preparers and their regulators or auditors, thus further reducing compliance and other related costs (particularly in jurisdictions

with more stringent regulatory regimes). Additional application guidance would also likely increase consistency in application, improving comparability between entities entering into similar transactions. Further, although the revenue recognition standard is newly-issued at present, the application guidance these staff members would propose would not be effective until the new leases standard becomes effective. Those staff members that support additional application guidance also note that existing U.S. GAAP has had specific guidance (the guidance from FAS 98, now included in Subtopic 840-40) to assist entities in applying real estate specific sale requirements to real estate sale and leaseback transactions for many years. There have not been issues of preparers extrapolating that guidance inappropriately to other types of transactions. Similarly, these staff members think that providing application guidance narrowly tailored to the specific circumstances of a sale and leaseback transaction, contained within the leases standard, would have limited risk of unintended consequences.

Staff recommendation

43. Based on the analysis above, the staff recommend the following with respect to determining whether a sale has occurred in a sale and leaseback transaction:

    (a) The Boards reaffirm that the seller-lessee should base its determination of whether there is a sale of the underlying asset on the definition of a sale in the new revenue recognition guidance (that is, an entity should account for the sale of an asset when the customer obtains control of that asset).

    (b) The Boards clarify application of the revenue recognition guidance to sale and leaseback transactions by:

        (i) Clarifying for U.S. GAAP preparers that a sale does not occur if the leaseback is effectively a repurchase of the underlying asset (that is, a Type A lease for the seller-lessee). No similar guidance would be proposed for IFRS preparers.

(ii) Clarifying that, if the seller-lessee has a repurchase option with respect to the underlying asset, the buyer-lessor would not obtain control of that asset. A nonsubstantive purchase option would not, however, preclude a sale.

(iii) Reaffirming that the presence of the leaseback does not preclude the seller-lessee from concluding that it has sold the underlying asset to the buyer-lessor.

(c) In addition, some of the staff recommend that the Boards include additional application guidance about how to apply the control guidance in the new revenue recognition standard to a sale and leaseback transaction, of the nature described in the staff analysis above. Other staff members do not think additional application guidance should be provided.

Question 1-2 – Determining whether a sale has occurred

Question 1 – Do the Boards agree with the staff recommendations outlined above, that is:

(a) Determining whether a sale has occurred in a sale and leaseback transaction based on the definition of a sale in the new revenue recognition guidance?

(b) Clarifying that a sale does not occur if the leaseback is a Type A lease from the perspective of the seller-lessee (FASB only)?

(c) Clarifying that, if the seller-lessee has a substantive repurchase option with respect to the underlying asset, no sale has occurred?

(d) Reaffirming that the presence of a leaseback does not preclude the seller-lessee from concluding that it has sold the underlying asset to the buyer-lessor?

If not, what do the Boards prefer?

Question 2 – Do the Boards wish to include additional application guidance to assist entities in applying the control principle in the new revenue recognition standard to sale and leaseback transactions?

Accounting for the sale/purchase

44. Some staff members think that the Boards should reaffirm the guidance proposed in the 2013 ED to account for the sale (by the seller-lessee) and the purchase (by the buyer-lessor) in accordance with other U.S. GAAP and IFRSs. These staff members note that:
    (a) Any sale of a nonfinancial asset not within the scope of another Topic or IFRS would be governed by principles consistent with those in the new revenue recognition standard, regardless of whether the sale is to a customer; and
    (b) The purchase of the asset and the accounting by both parties for the costs of the transaction would be governed by other Topics/IFRSs.
45. Some constituents have suggested that the Boards should require deferral of the gain on a sale subject to a sale and leaseback transaction (more broadly consistent with existing U.S. GAAP). However, these staff members think that if a sale of a nonfinancial asset has occurred (based on the criteria in the new revenue recognition standard), the presence of the leaseback should not affect the recognition of any gain or loss resulting from the sale if the transaction is at market value (see "off-market" discussion below).

Restrict gain recognition to that portion attributable to the residual asset

46. In contrast, other staff members think that the presence of the leaseback should affect the recognition of any *gain* (but not any *loss*) resulting from the sale. Those staff members think that this proposal is particularly relevant under the IASB's lessee accounting model.
47. In a sale and leaseback transaction, the seller-lessee sells the underlying asset and immediately leases it back for the period of the leaseback. Although from a legal and accounting standpoint, the seller-lessee has sold the asset, it continues to have the right to use the asset for a period of time after entering into the sale and leaseback transaction. Consequently, from an *economic* standpoint, the seller-lessee

has sold its interest in the residual value of the underlying asset at the end of the leaseback, and has retained its right to use the asset for the period of the leaseback.

48. To reflect that, economically, the seller-lessee has given up its rights to the residual asset (and retained its right to use the asset for the period of the leaseback), a seller-lessee could account for a sale and a leaseback as follows:

    (a) As the sale of a portion of the underlying asset—that is, a sale of its interest in the residual; and

    (b) The leaseback of the asset for the period of the lease (which is not a "new" right-of-use but the retention of its right to use the asset that was embedded within its ownership rights of the underlying asset before the sale and leaseback).

49. Importantly, this approach would *not* account for all sale and leaseback transactions as partial sales. Only those transactions that qualify as a sale of the entire underlying asset according to the revenue recognition guidance would be subject to this "partial gain recognition approach." A transaction that resulted in a "failed sale" (for example, a sale and leaseback that includes a substantive repurchase option) would be accounted for as a financing transaction.

50. The seller-lessee and the buyer-lessor would account for the transaction as the sale/purchase of the underlying asset and a leaseback (within the leases standard). Therefore, the seller-lessee would derecognize the underlying asset and recognize a ROU asset. However, the seller-lessee would measure the ROU asset as a proportion of the previous carrying amount of the underlying asset, rather than at the present value of the leaseback payments (as adjusted for items such as rent prepayments) at the date of the transaction. The consequence of measuring the ROU asset in that way is that any gain recognized at the commencement of the transaction would relate only to the residual interest.

51. To illustrate, consider the following example. Seller-lessee sells a building (with a carrying amount of CU2,000,000) for CU3,000,000 (the observable market value of the building on the date of the sale), and leases it back for 10 years for CU182,000

per year (assume a 6% discount rate). Under this approach, a seller-lessee would account for the transaction as follows:

DR ROU asset 1,340,000
CR Lease liability 1,340,000 (present value of lease payments)
DR Cash 3,000,000
CR Building 2,000,000
CR Gain on sale 553,000 (CU1,000,000 x 1,660,000/3,000,000)
CR ROU asset 447,000 (CU1,000,000 x 1,340,000/3,000,000)

The seller-lessee would, therefore, recognize the ROU asset at CU893,000, which would represent the portion of the previous carrying amount of the building (CU2,000,000) relating to the ROU asset. The gain recognized of CU553,000 would represent the portion of the gain relating to the residual asset.

52. Were the FASB to consider this partial gain recognition approach, it would apply only to Type B leasebacks (Type A leasebacks would disqualify the sale leg of the transaction from sale accounting if the Boards agree with the staff recommendation above). The seller-lessee would recognize the deferred gain of CU447,000 on a straight-line basis as a reduction of the single Type B operating lease expense and would present it at each reporting date net in the ROU asset (similar to the presentation of accrued rent).

53. Under this approach, if the leaseback were for a short portion of the life of the asset, the seller-lessee would recognize a larger proportion of any gain on sale of the asset. This would reflect that, economically, the seller-lessee has sold a larger proportion of the underlying asset by retaining the right to use that asset for only a short period of time. In contrast, if the leaseback were for a larger portion of the life of the asset, the seller-lessee would recognize a smaller proportion of any gain on sale of the asset. At the extreme, if the leaseback were for all of the economic life of the underlying asset, the staff would expect no gain to be recognized on sale under this approach.

54. As noted above, some staff members recommend this approach. The staff think it would be inappropriate for a seller-lessee to recognize a gain on the sales leg of *all*

transactions that are structured as a sale and leaseback. For example, if the leaseback were for all of the remaining life of the underlying asset, the seller-lessee has given up very little, if any, of its rights to the economic benefits embedded in the underlying asset. In that scenario, the staff think that it would not faithfully represent the transaction for the seller-lessee to uplift the value of its assets and recognize a gain at the date of the transaction.

55. In this scenario, U.S. GAAP seller-lessees would not recognize a gain, if the FASB agree with the staff's recommendations earlier in this paper. This is because, under the FASB's lessee model, the leaseback would be a Type A lease and the transaction would be accounted for as a financing transaction. However, the IASB's lessee model does not have a classification line that distinguishes between leases that are in-substance purchases and other leases. Consequently, if the IASB wished to prevent the recognition of a gain in this scenario, the IASB would either be required to:

    (a) Introduce a distinguishing line between different types of leases *only* for sale and leaseback transactions, which would not exist for lessees in any other scenarios; or

    (b) Adopt the partial gain recognition approach discussed above in this section of the paper.

56. Some staff recommend the partial gain recognition approach for IFRS seller-lessees because it would:

    (a) Restrict the recognition of any gain on sale in a way that, economically, reflects the rights to the underlying asset that have been given up and retained by the seller-lessee.

    (b) Appear to be relatively straight-forward to apply, and no more complex than introducing a classification test only for sale and leaseback transactions. The seller-lessee would already have all of the information required to calculate the partial gain on sale (that is, the fair value of the underlying asset and the initial measurement of the ROU asset).

(c) Avoid some possible unintended consequences of applying the financial instruments guidance to some sale and leaseback transactions. For example, in a sale and leaseback for which the buyer-lessor retains an interest in the residual that is expected to be, say, 5 percent of the value of the asset, the buyer-lessor would account for that leaseback within the leases standard, which has specific guidance on how to account for its interest in the residual.

57. Other staff members do not recommend the partial gain recognition approach. Those staff members think that there is no "special" reason why, if a seller-lessee concludes that a sale of a nonfinancial asset has occurred, a gain should not be recognized in the same manner as for any other sale of a nonfinancial asset. These staff members generally think that it would be more straight-forward to define a threshold at which a sale would not occur (such as an in-substance purchase), while still accounting for all of those transactions determined to be sales in the same manner as any other sale. Those staff members think that an in-substance purchase test (based either on the FASB lessee classification test or the IASB lessor classification test, both derived from existing IAS 17), which for *most* leasebacks would be easy to apply and the result obvious, would be less complex than applying the partial gain recognition approach to *all* sale and leaseback transactions.

Questions 3-4 – Accounting for the sale/purchase

Question 3 – Which of the following approaches to accounting for the gain in a sale and leaseback transaction, in the absence of "off-market" terms, do the Boards prefer (account for the gain in the same manner as any other gain resulting from the sale of a nonfinancial asset, as was proposed in the 2013 ED, *or* limit any gain recognized on the sale of an asset to the amount of the gain relating to the residual asset)?

Question 4 – Do the Boards agree with the staff recommendations that (a) if a sale occurs, the seller-lessee should recognize any *loss* on the sale, in the absence of "off-market" terms, in the same manner as any other loss incurred on the sale of a nonfinancial asset, and (b) the buyer-lessor should account for the *purchase* of the underlying asset in accordance with other existing U.S. GAAP or IFRSs?

Accounting for the leaseback

58. The staff think that the seller-lessee and the buyer-lessor should account for the leaseback (if a sale/purchase has occurred) in accordance with the respective lessee and lessor guidance. In effect, if the sale is a separable accounting event (that is, separable from the leaseback), then the leaseback is no different from any other lease for either party. This would reaffirm the corresponding proposal in the 2013 ED.

59. The staff note, however, that the partial gain recognition approach discussed in the section above would affect the accounting for the leaseback by resulting in:

    (a) A lease commencement date adjustment to the ROU asset for IFRS preparers; and

    (b) An ongoing requirement throughout the leaseback term for U.S. GAAP preparers to account for the initially deferred gain on the sale of the underlying asset.

Question 5 – Accounting for the leaseback
Question 5 – Do the Boards agree that, if a sale/purchase is determined to have occurred, the seller-lessee and the buyer-lessor should account for the leaseback in the same manner as any other lease (that is, in accordance with the lessee and lessor guidance, respectively)?

Accounting for "Off-market" terms

Determining whether the sale and leaseback is off-market and calculating the adjustment

60. Paragraph 114 (Paragraph 842-40-30-1) in the 2013 ED stated that "if the consideration for the sale of an asset is not at fair value or the **lease payments** are not at market rates," the seller-lessee and the buyer-lessor would adjust the initial sale accounting. Some constituents read this proposal to require the seller-lessee and buyer-lessor to determine both the fair value of the underlying asset and the

market lease payments for the underlying asset in assessing whether an adjustment to the stated terms is necessary, as well as *requiring* determination of market lease payments in order to record any adjustment for off-market terms. Many of these constituents suggest that the fair value of the underlying asset, not the fair value of the lease payments, should be used to determine whether a sale is at fair value and measure any adjustment for off-market terms. These constituents assert that the fair value of the underlying asset sold is generally more readily determinable than market rentals. Consequently, the market value of the asset is generally a better indicator of whether the transaction price is at-market and may provide for a more accurate adjustment.

61. The staff think that the Boards could simplify the guidance by clarifying that an entity does not, necessarily, need to determine the fair value of *both* the underlying asset and the market lease payments. The staff think that requiring an entity to determine the fair value of *both* the underlying asset and the market lease payments is likely to be unnecessary given that any overpayment for the underlying asset by the buyer-lessor would often be accompanied by above-market rental fees, and vice versa. In addition, requiring measurement of both the underlying asset and the market lease payments carries additional complexity and would be inconsistent with other guidance that generally directs an entity to select the single benchmark measure that is most readily measurable.

62. Therefore, an entity should maximize the use of observable prices and observable information in selecting the most appropriate benchmark to use in determining if the transaction is at-market or off-market *and* in calculating the accounting adjustment for off-market terms. The staff think this will result in less complex, and more accurate, accounting. For example, assume that identical or similar assets to the underlying asset are regularly sold separately such that there is an observable fair value for the underlying asset at the time of the transaction. If comparable rental rates are not readily available or are highly variable, the determination of the gain or loss, and any adjustment thereto, should be based on the observable fair value of the underlying asset rather than an estimate of what would constitute market rental fees.

63. To support this recommendation, assume the following example:

    A sale and leaseback of a building for 10 years. The sale price is CU3,500,000; the observable market value of the building is CU3,000,000; and the carrying value is CU2,000,000. Contractual annual lease payments are CU250,000 and the lessee's incremental borrowing rate is 6%.

64. In this example, using the observable market value of the building to adjust for the off-market sale, the seller-lessee would recognize a gain on the sale of CU1,000,000 and total expense (lease expense plus interest on the additional financing from the buyer-lessor) of CU2,000,000 over the leaseback term. If the market rental payments were not readily determinable, the gain and the total lease expense could vary widely depending on how the market rental amount was determined. For example:

    (a) If the annual market rental payments at contract inception were estimated at CU220,000, the seller-lessee would recognize a gain on the sale of CU1,279,197 and total expense of CU2,279,197.

    (b) If the annual market rental payments at contract inception were estimated at CU170,000, the seller-lessee would recognize a gain on the sale of CU911,183 and total expense of CU1,911,183.

65. The converse can be true as well if there are observable market rental prices, but the fair value of a similar asset is highly variable or uncertain. Therefore, the staff think that both parties should maximize the use of observable information in determining whether a sale and leaseback transaction is at-market and in determining any off-market adjustment.

<u>Seller-Lessee Accounting for "Off-Market" Terms</u>

66. The staff think that, if the sale price of the underlying asset is less than its fair value, the difference is, in effect, a prepayment of rent by the seller-lessee. Consequently, an entity should account for that difference in the same manner as any other rent prepayment (that is, as an adjustment to the ROU asset). This is consistent with the

proposals in the 2013 ED. The increased ROU asset would be subject to impairment testing under Topic 360 or IAS 36.

67. If the sale price *exceeds* the fair value of the underlying asset, the staff think that there are two possible approaches the Boards could adopt:

    (a) *Approach A* – Would recognize the amount of any excess sale price as an additional financial liability for the seller-lessee (whether calculated as the difference between the fair value of the underlying asset and the sale price *or* as the difference between the present value of the contractual leaseback payments and market rental payments), as was proposed in the 2013 ED.

    (b) *Approach B* – Would recognize the lease liability at the amount of the *contractual* leaseback payments, with the amount of any excess sale price recorded as an adjustment to the opening ROU asset.

68. Both approaches would result in the same initial measurement of the ROU asset. However, Approach A would treat the excess sale price as additional financing to the seller-lessee, separate from the leaseback. Approach B would consider the excess sale price as, economically, an adjustment to the lease payments.

69. For IFRS seller-lessees, there would be little difference in outcomes between the two approaches. The income statement, statement of cash flows, and the balance sheet would be effectively the same under either approach. However, inclusion of this amount in the lease liability *would* affect the entity's lease-related disclosures (for example, by including such amount in the lease payment maturity analysis, and including the expense effect in any quantitative disclosure of lease expenses).

70. For U.S. GAAP seller-lessees, the difference between the two approaches would be more pronounced.

    (a) First, the effect on the income statement in each period during the leaseback would be different between the approaches. Assume the same example briefly outlined above: the sale of a building for CU3,500,000 (with a 40 year remaining economic life and fair value of CU3,000,000)

and a 10-year leaseback with annual payments of CU250,000. Assume that the seller-lessee calculated the off-market adjustment as CU500,000 (that is, the difference between the sale price and the fair value of the underlying asset). Under Approach A, with a discount rate of 6%, the entity would recognize total expense (lease expense plus interest on the additional buyer-lessor financing) of CU212,066 in Year 1 of the leaseback, which would decline to CU185,911 in Year 10. Under Approach B, the entity would recognize lease expense only of CU200,000 each year (calculated as the total contractual lease payments – the excess sale price)/10 years). Therefore, Approach B would effectively disregard the financing nature of the excess sale price.

(b) Second, the effect on the statement of cash flows would be different. Under Approach A, the cash outflows with respect to the additional buyer-lessor financing would be split between operating (for interest) and financing (for principal repayment). Under Approach B, all of the cash outflows related to the leaseback, including those that could be viewed as repayment of the excess sale price, would be classified as operating cash flows.

(c) Lastly, consistent with that outlined for IFRS preparers, inclusion of the excess sale price in the lease liability, rather than accounting for the excess as a separate financial liability, would be expected to affect the entity's lease-related disclosures.

71. The staff think that an excess of the sale price or the leaseback payments to the fair value of the underlying asset or market lease payments, respectively, should be reflected as additional financing to the seller-lessee. Therefore, Approach A is the most appropriate approach for U.S. GAAP seller-lessees. The staff further think that this is the most appropriate approach for *both* U.S. GAAP and IFRS seller-lessees because of the effect these additional amounts would have on the lease-related disclosures. In particular, the staff would be concerned about:

(a) The effect that characterization of the off-market adjustment in the income statement as additional lease expense would have for those users that base key aspects of their analyses on lease expense; and

(b) The effect on those users that rely on the lease maturity analysis to predict ongoing (rather than potentially "one-off") cash flow requirements of the entity.

Buyer-Lessor

72. For the buyer-lessor, some constituents suggested that the Boards could have proposed that the fair value of the underlying asset be considered its acquisition cost with any difference between that amount and the price paid treated as an adjustment of the lease payments. Under this approach, the buyer-lessor would reflect:

    (a) A deficiency between the purchase price and the fair value of the asset (or, if more readily determinable, between the present value of the contractual lease payments and market lease payments) as a prepayment of rent received from the seller-lessee; and

    (b) Any excess between the purchase price and the fair value of the asset as other financing provided to the seller-lessee

    The underlying asset would be recorded by the buyer-lessor at the purchase price net of the off-market adjustment.

73. This approach would be consistent with the proposals in the 2013 ED other than to clarify that the "off-market" adjustment could be calculated based on the fair value of the underlying asset, rather than the fair value of the lease payments, if the former is more readily determinable.

74. Using the same example presented above (sale-leaseback with a CU3,500,000 sale price; CU3,000,000 asset fair value; CU2,000,000 carrying value; and 10-year leaseback with annual payments of CU250,000), the buyer-lessor would record the underlying asset at CU3,000,000, and treat the CU500,000 excess of the purchase price to fair value as additional financing provided to the seller-lessee. If the purchase price were CU2,500,000, the buyer-lessor would still recognize the

underlying asset at CU3,000,000; however, the CU500,000 difference would be accounted for as prepaid rent and recognized as lease income together with, and in the same manner as, the contractual leaseback payments.

Staff Recommendations for "Off-Market" Sale and Leaseback Transactions

75. With respect to sale and leaseback transactions entered into at "off-market" terms, the staff recommend the following:

    (a) That both parties determine any potential "off-market" adjustment based on whichever benchmark (that is, the difference between the sale price and the fair value of the underlying asset *or* the difference between the present value of the contractual lease payments and the present value of fair market value lease payments) provides more readily determinable evidence.

    (b) That the seller-lessee account for any "off-market" adjustment that:

        (i) Reflects a *deficiency* of the sale price or the contractual leaseback payments as compared to the fair value of the underlying asset or fair market lease payments, respectively, as an adjustment to the initial leaseback ROU asset in the same manner as a prepayment of rent.

        (ii) Reflects an *excess* of the sale price or the contractual leaseback payments as compared to the fair value of the underlying asset or fair market lease payments, respectively, in accordance with "Approach A" (that is, as additional financing from the buyer-lessor that is separate from the lease liability).

    (c) That the buyer-lessor recognize its purchase of the underlying asset at the contractual purchase price together with any off-market adjustment, and:

        (i) Account for a *deficiency* of the sale price or the contractual leaseback payments as compared to the fair value of the

underlying asset or fair market lease payments, respectively, as a prepayment of rent by the seller-lessee.

(ii) Account for an *excess* of the sale price or the contractual leaseback payments as compared to the fair value of the underlying asset or fair market lease payments, respectively, as additional financing provided to the seller-lessee.

76. The following example demonstrates accounting for an off-market sale-leaseback by both the seller-lessee and the buyer-lessor based on the staff recommendations (and based on the full gain recognition approach, rather than the approach that would restrict the gain on the sale to the amount attributable to the residual asset):

Example – Sale and leaseback transaction at off-market terms

An entity (Seller-Lessee) sells a building with a remaining economic life of 40 years to an unrelated entity (Buyer-Lessor) for cash of CU3,500,000. Immediately before the transaction, the asset is carried at a cost of CU2,000,000. At the same time, Seller-Lessee enters into a contract with Buyer-Lessor for the right to use the asset for 10 years, with annual payments of CU250,000 payable at the end of each year. The terms and conditions of the transaction are such that Buyer-Lessor obtains control of the asset in accordance with the requirements in the forthcoming revenue recognition standard. Accordingly, Seller-Lessee and Buyer-Lessor account for the transaction as a sale and leaseback. This example ignores any initial direct costs associated with the transaction.

Similar assets have been sold in separate sales transactions recently; the sale prices for which are publicly available. Based on those recent standalone sales, the fair value of the underlying asset is CU3,000,000. Both Seller-Lessee and Buyer-Lessor determine that those observable standalone sales provide better evidence of the off-market adjustment required than determining the market rental payments for the leaseback. Because the consideration for the sale of the asset is not at fair value, Seller-Lessee and Buyer-Lessor are required to make adjustments to recognize the transaction at fair value.

The leaseback is classified as a Type B lease by Buyer-Lessor (and by Seller-Lessee under U.S. GAAP).

Seller-Lessee Accounting

At the commencement date, Seller-Lessee accounts for the transaction as follows (the lessee's incremental borrowing rate is 6%; the rate the lessor charges the lessee is not available):

Cash	CU3,500,000		
Right-of-use asset	CU1,340,022[1]		
	Asset (PP&E)		CU2,000,000
	Lease liability		CU1,340,022[2]
	Additional financing		CU 500,000[3]
	Gain on sale		CU1,000,000[4]

[1] Equal to the lease liability

[2] PV of contractual leaseback payments – CU500,000 (off-market adjustment)

[3] CU3,500,000 (sale price) – CU3,000,000 (fair value of underlying asset)

[4] CU3,500,000 (sale price) – CU2,000,000 (carrying value) – CU500,000 (off-market adjustment)

Each period subsequent to lease commencement, Seller-Lessee allocates CU182,066 of each leaseback payment to the lease and CU67,934 to the financial liability (CU250,000 x [CU500,000/CU1,840,022] = CU67,934).

Under U.S. GAAP, Seller-Lessee would recognize CU182,066 as lease expense each period of the 10-year leaseback and interest expense on the financing liability (CU30,000 in Year 1, declining to CU3,485 in Year 10). The lease liability and the ROU asset at the end of each year of the lease term will equal the present value of the remaining lease payments allocable to the lease (for example, at the end of Year 1, the lease liability and ROU asset will equal CU1,238,357, which is the present value of 9 remaining lease payments allocable to the lease of CU182,066 discounted at 6%).

Under IFRS, Seller-Lessee will recognize ROU asset amortization of CU134,002 each year of the 10-year leaseback plus interest expense on both the lease liability and the additional financing (the combined interest expense equals CU110,401 in Year 1 and CU14,151 in Year 10).

Buyer-Lessor Accounting

At the commencement date, Buyer-Lessor accounts for the transaction as follows:

Buyer-Lessor would determine the interest rate implicit in the leaseback (even though the leaseback is not a Type A lessor lease). Buyer-Lessor estimates the residual value of the building at the end of the leaseback at CU2,900,000; which results in an implicit rate of 8.104% (that is, the discount rate that results in the present value of the sum of the leaseback payments and the residual value equalling the CU3,000,000 fair value of the building). At the commencement date, Buyer-Lessor accounts for the transaction as follows:

Asset (PP&E)	CU3,000,000[5]	
Financial asset	CU 500,000[6]	
Cash		CU3,500,000

[5] CU3,000,000 (fair value of the underlying asset)

[6] CU3,500,000 (purchase price) – CU3,000,000 (fair value of underlying asset)

Each period of the leaseback, Buyer-Lessor receives a CU250,000 payment from Seller-Lessee. Buyer-Lessor allocates CU74,866[7] of each contractual leaseback payment to the financial asset (repayment of principal) and CU175,134 to the lease. Buyer-Lessor recognizes CU175,134 in lease income plus interest income on the financial asset (interest income of CU40,522 in Year 1; CU5,613 in Year 10) in each year of the leaseback.

[7] CU250,000 x (CU500,000 / CU1,669,652[8]) = CU74,866

[8] PV of 10 payments of CU250,000 (in arrears) discounted at 8.104%

Question 6 – Accounting for "off-market" terms

Question 6 – Do the Boards agree with the staff recommendations outlined above on entities' accounting for sale and leaseback transactions entered into at "off-market" terms? If not, with which recommendations do the Boards disagree and what would they prefer?

Accounting for “failed” sale and leaseback transactions

Seller-Lessee

77. Consistently with the proposals in the 2013 ED, the staff think that if there is no sale the “seller-lessee” should not derecognize the underlying asset, but instead should recognize any proceeds from the “buyer-lessor” as a financial liability. The seller-lessee would continue to recognize depreciation of the underlying asset.
78. As the seller-lessee makes the scheduled payments in the contract, it would allocate those payments between interest expense on the financial liability (calculated using the rate implicit in the leaseback, if available, and if not, the seller-lessee incremental borrowing rate) and repayment of principal on the financial liability.
79. At the end of the “leaseback” period (or at whatever point before that the buyer-lessor obtains control of the underlying asset), the seller-lessee would recognize any remaining balance of the financial liability as the proceeds on the final sale of the underlying asset. The gain or loss recognized at that point would reflect any difference between those proceeds and the carrying amount of the underlying asset.

Buyer-Lessor

80. When no sale occurs, the buyer-lessor is providing financing to the “seller-lessee.” The buyer-lessor would account for the initial payment to the seller-lessee as a financial asset. As the seller-lessee makes payments over the leaseback term, the buyer-lessor recognizes a portion as interest income on the financial asset and the remainder as a reduction of the principal balance of the financial asset.
81. At the end of the leaseback term, or whenever the buyer-lessor obtains control of the underlying asset, the remaining balance of the financial asset is considered the cost of the underlying asset that the buyer-lessor acquires at that point.
82. Both the proposals for the seller-lessee and for the buyer-lessor are consistent with the *financing method* used for most failed sale and leasebacks under existing U.S. GAAP (the *deposit method* is also used for some failed sale and leasebacks). There are no failed sale and leasebacks under existing IFRS.

Question 7 – Accounting for "failed" sale and leaseback transactions
Question 7 – Do the Boards wish to reaffirm the proposal in the 2013 ED that the parties to a "failed" sale and leaseback transaction should account for the transaction as a financing transaction?

Accounting for sale and leaseback transactions during transition

83. The staff think that the Boards could provide significant transition relief to entities that engage in sale and leaseback transactions by not requiring an entity to retrospectively reassess whether a transaction would have qualified as a sale (for the seller-lessee) or a purchase (for the buyer-lessor) at contract inception based on the new revenue recognition guidance. Some constituents have expressed the view that the cost, time, and effort for parties to reassess these contracts will be significant. For example, it could require an entity to go back 20 years or more and attempt to reassess whether a sale would have occurred at that time based on the new requirements in the revenue recognition standard.

84. The staff think that, in many instances, transactions that were accounted for as sale and leaseback transactions would continue to qualify as a sale under the revenue recognition guidance. In addition, in the context of transactions that resulted in a sale and capital/finance leaseback, the outcome of requiring a retrospective approach would not be significantly different from not requiring such a retrospective approach. This is because the combination of the Type A lease accounting (Type A, as this is referring to existing *capital/finance* leasebacks, the accounting for which under existing guidance is similar to the Type A lessee accounting approach) and the continued recognition and amortization of the deferred gain would approximate the accounting that would have resulted from finance ("failed sale") accounting (see table that follows).

Continuing Existing Leaseback Accounting	**Retrospectively Restating to "Failed Sale" Accounting**
Balance Sheet:	***Balance Sheet:***

− ROU Asset − Lease Liability − Deferred Gain	− Underlying Asset − Financial Liability
Income Statement: − Amortization of ROU asset − Interest on Lease Liability − Amortization of Deferred Gain	***Income Statement:*** − Depreciation of Underlying Asset − Interest on Financial Liability

85. For any "failed sales" that resulted from applying existing U.S. GAAP (that is, real estate sale and leaseback transactions that did not qualify as sales), the staff would propose that each failed sale and leaseback that remains failed as of the effective date (for example, a real estate sale with a 10-year leaseback for which the 10-year leaseback period has not expired) be reassessed as to whether a sale would have occurred under the new revenue recognition standard at contract inception or at any other point in time before the effective date.

86. This reassessment notion would be consistent with the transition requirements in the new revenue recognition standard, which stipulates that any contracts that are not "completed" based on legacy U.S. GAAP or IFRS as of the effective date, which would include a failed sale, would be reassessed and accounted for in accordance with the entity's elected transition method.

Buyer-Lessor

87. A buyer-lessor involved in a sale and leaseback transaction (that is, that qualifies as a sale/purchase) accounts for the transaction as the acquisition of an asset and a corresponding leaseback of that asset to the seller-lessee. Consequently, if not required to reassess whether a purchase of the asset has occurred, a buyer-lessor would simply apply whatever transition requirements are applicable to all other lessors. Lessor transition will be discussed by the Boards at a future joint meeting.

Seller-Lessee

88. In addition to any transition requirements with respect to the leaseback (transition for lessees with respect to existing leases will be discussed at a future Board meeting), the staff think that a seller-lessee should account for any deferred gain on a previous sale and leaseback in one of the following ways:

    (a) For leasebacks classified as capital/finance leasebacks under existing U.S. GAAP and IFRS, the entity should continue amortizing the gain in the same manner as under existing guidance. This is consistent with the proposals in the 2013 ED. The staff do not think that the Boards should require the seller-lessee to retrospectively account for the sale and leaseback as a financing. This would increase complexity without any significant difference in outcomes.

    (b) For leasebacks classified as operating leasebacks *and* that were entered into at market terms, the entity should recognize any deferred gain as a cumulative effect adjustment to equity at the earlier of the beginning of the earliest period presented or the date of sale. This would, in effect, adjust the entity's financial statements as if those historical gains were accounted for in the same manner as the staff are recommending for gains resulting from sale and leaseback under the final leases standard.

    (c) The entity should recognize any gains or losses that were deferred as a result of "off-market" terms in the sale and leaseback as (i) an adjustment to the leaseback ROU asset (if a deferred loss) or (ii) accounted for as a remaining financial liability at the beginning of the earliest period presented such that as of that date, the accounting is consistent with the proposals outlined above for "off-market" terms. The staff do not think gains or losses resulting from off-market terms should be "written-off" at transition because they reflect *continued* financing (unaffected by transition to a new leases standard) and should continue to affect the seller-lessee's ongoing lease expense.

89. If the Boards were to adopt the partial gain recognition approach outlined earlier in this paper for any gains on the sale of an underlying asset in a sale and leaseback transaction, transition to that approach *could* be complex. If the Boards were to require retrospective transition for this approach, a seller-lessee would need to retrospectively revisit each of their sale and leasebacks that were not completed (that is, for which the leaseback term had not ended) at the beginning of the earliest reporting period presented. The costs to effect this retrospective reporting may be significant because it would require, among others, a seller-lessee:

    (a) To recover historical information on carrying values and fair values at the date of sale of the underlying asset; and

    (b) To both (i) "unwind" the previous gain accounting (whether recognized upfront under IFRS or deferred under U.S. GAAP) and (ii) re-record a partial gain at the date of sale and recognize the deferred portion of the gain over the leaseback term.

90. The staff recommend, that if the Boards adopt the partial gain recognition approach, they should choose to allow a simplified transition method that would account for deferred gains from existing sale and leaseback transactions in the manner recommended above. This would mean that a seller-lessee would apply the partial gain recognition approach only to new sale and leaseback transactions entered into after the effective date of the new leases standard. The staff are recommending this simplified approach for cost and complexity reasons. It is possible that retrospectively applying the partial gain recognition approach to sale and leaseback transactions not completed before the beginning of the earliest reporting period presented could have a material effect on the seller-lessee's balance sheet and income statement.

Questions 8-10: Accounting for sale and leaseback transactions during transition
Question 8: Do the Boards agree that entities should reassess whether there has been a sale in a sale and leaseback transaction only where the transaction is still being accounted for as a "failed sale" at the effective date (that is, those transactions previously

accounted for as sales by the seller-lessee and purchases by the buyer-lessor would not be reassessed)?

Question 9: Do the Boards agree with the proposals outlined above as to how seller-lessees should account for deferred gains or losses resulting from sale and leaseback transactions during transition?

Question 10: If the Boards adopt the partial gain recognition approach for seller-lessees, do the Boards agree with the staff recommendation to require a simplified transition approach to sale and leaseback transactions not completed before the beginning of the earliest period presented, as described above?

Appendix A – Proposed Changes to the 2013 ED

A1. The following table lists the proposed guidance in the 2013 ED that relates to sale-leaseback transactions and demonstrates which proposals would change as a result of the staff recommendations in this paper:

Proposals in the 2013 ED	Proposed Changes
110. If an entity (the transferor) transfers an asset to another entity (the transferee) and leases that asset back from the transferee, both the transferor and the transferee shall account for the transfer contract and the lease in accordance with paragraphs 111–117.	No material changes anticipated.
Determining whether the transfer of the asset is a sale 111. An entity shall apply the requirements for determining when a performance obligation is satisfied in [draft] {standard} Revenue from Contracts with Customers when determining whether the transfer of an asset shall be accounted for as a sale of the asset.	No material changes anticipated.
112. The existence of the leaseback (ie the transferor's right to use the asset for a period of time) does not, in isolation, prevent the transferee from obtaining control of the asset. However, if the leaseback provides the transferor with the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, then the transferee does not obtain control of the asset and the transfer is not a sale. The transferor is considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, if either of the following occurs: (a) the lease term is for the major part of the remaining economic life of the asset; or (b) the present value of the lease payments accounts for substantially all of the fair value of the asset.	Remove criteria (a) and (b), and instead clarify that a *transferee* (buyer-lessor) is not considered to have obtained control of the underlying asset (that is, to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset) if: a) For U.S. GAAP preparers, the leaseback is a Type A lease from the perspective of the seller-lessee; or b) There is a repurchase agreement that would preclude sale accounting based on the new revenue recognition standard Provide additional application guidance with respect to applying the new revenue recognition standard to sales of assets in the context of a sale-leaseback transaction (*if the Boards decide to do so in Question 2*).
Transfer of the asset is a sale 113. If a transferee obtains control of the asset in accordance with the requirements for determining when a performance obligation is satisfied in [draft] {standard} Revenue from Contracts with Customers: (a) the transferor shall account for a sale in accordance with applicable Standards and for	No material changes anticipated if the Boards retain the proposals in the 2013 ED. Changes are anticipated regarding the recognition of any gain on sale if the Boards adopt the approach that would restrict the gain recognized at the date of sale by the seller-lessee to the amount attributable to the residual asset.

the lease in accordance with lessee accounting in this [draft] Standard. (b) the transferee shall account for a purchase in accordance with applicable Standards and for the lease in accordance with lessor accounting in this [draft] Standard.	
114. If the consideration for the sale of an asset is not at fair value or the lease payments are not at market rates, an entity shall make the following adjustments to recognize the sale at fair value: (a) the transferor shall measure the right-of-use asset and the gain or loss on disposal of the underlying asset to reflect current market rates for lease payments for that asset. The transferor shall subsequently account for the lease to reflect those current market rates. (b) the transferee shall measure the lease receivable and the residual asset for Type A leases, or the underlying asset for Type B leases, to reflect current market rates for lease payments for that asset. The transferee shall subsequently account for the lease to reflect those current market rates.	Changes are anticipated to align this guidance with the staff recommendations in paragraph 75 of this paper.
Transfer of the asset is not a sale 115. If the transferee does not obtain control of the asset in accordance with the requirements for determining when a performance obligation is satisfied in [draft] {standard} Revenue from Contracts with Customers: (a) the transferor shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with applicable Standards; and (b) the transferee shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with applicable Standards.	No material changes anticipated.
Disclosure 116 If a transferor or a transferee enters into a sale and leaseback transaction that is accounted for in accordance with paragraphs 113–114, it shall provide the disclosures required by paragraphs 58–67 or 98–109. 117 In addition to the disclosures required by paragraphs 58–67, a transferor that enters into a sale and leaseback transaction shall disclose both of the following: (a) the main terms and conditions of that	No material changes anticipated.

transaction, and (b) any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.	
Sale and leaseback transactions before the beginning of the earliest comparative period presented C19 If a previous sale and leaseback transaction was accounted for as a sale and a finance lease in accordance with IAS 17, an entity shall do all of the following: (a) not reassess the transaction to determine whether it is a sale and leaseback transaction; (b) not remeasure lease assets and lease liabilities at the beginning of the earliest comparative period presented; and (c) continue to amortize any deferred gain or loss in respect of the transaction.	No material changes anticipated.
C20 An entity shall reassess the transaction to determine whether the transferee obtains control of the underlying asset in accordance with the requirements for determining when a performance obligation is satisfied in [draft] {standard} *Revenue from Contracts with Customers* if either of the following applies: (a) a previous sale and leaseback transaction was accounted for as a sale and an operating lease in accordance with Topic 840/IAS 17; or (b) a previous transaction was assessed to determine whether it was a sale and leaseback transaction in accordance with Topic 840/IAS 17, but it did not qualify for sale and leaseback accounting.	An entity will not be required to reassess a previous sale and leaseback that was accounted for as a sale and an operating leaseback. Therefore, only (b) would continue to apply and it would apply only to U.S. GAAP preparers.
C21 If a transferee obtains control of the underlying asset in accordance with the requirements for determining when a performance obligation is satisfied in [draft] {standard} *Revenue from Contracts with Customers*, a lessee shall use the requirements in paragraphs C8–C9 to measure lease assets and lease liabilities and shall derecognize any deferred gain or loss at the beginning of the earliest comparative period presented.	No material changes anticipated other than to specify that deferred gains or losses resulting from “off-market” terms in a sale and operating leaseback transaction should be accounted for as follows: a) Any deferred loss resulting from off-market terms should be recorded as an adjustment to the ROU asset at the beginning of the earliest comparative period presented b) Any deferred gain resulting from off-market terms should be accounted for as a remaining financial liability as of the beginning of the earliest comparative period presented.