STAFF PAPER

February 2015

REG IASB Meeting

Project	**Leases**
Paper topic	Transition – Sale and Leaseback Transactions

CONTACTS	Kathryn Donkersley	kdonkersley@ifrs.org	+44 207 246 6970
	Patrina Buchanan	pbuchanan@ifrs.org	+44 207 246 6468

Objective

1. The purpose of this paper is to discuss the transition requirements for lessees and lessors with respect to sale and leaseback transactions.

2. This paper does not address IFRS 1 *First-Time Adoption of International Financial Reporting Standards*. This is because the staff think that the recommendations in this paper are directly related to an entity transitioning from *existing* IFRS requirements and, therefore, should not be applicable upon first-time adoption.

3. This paper is structured as follows:

   (a) Summary of staff recommendations

   (b) Background

   (c) Feedback received on the 2013 ED

   (d) Staff analysis – seller-lessee

      (i) IAS 17 Sale and finance leasebacks

      (ii) IAS 17 Sale and operating leasebacks

   (e) Staff analysis – buyer-lessor

   (f) Staff recommendations and questions for the IASB

4. Throughout this paper:

   (a) the ‘date of initial application’ is used to describe the first day of the annual reporting period in which a lessee first applies the requirements of the new leases standard;

   (b) ‘historic sale and leaseback transaction’ is used to describe a sale and leaseback transaction that occurred before the date of initial application but for which the leaseback continues to be in place at the date of initial application.

Summary of Staff Recommendations

5. With respect to the transition requirements for sale and leaseback transactions, the staff recommend:

   (a) that the new leases standard does not require reassessment of historic sale and leaseback transactions to determine whether a sale occurred in accordance with IFRS 15 *Revenue from Contracts with Customers*;

   (b) that, with respect to sale and leaseback transactions that were classified as finance leases under IAS 17 *Leases*, a seller-lessee should not perform any retrospective accounting specific to the sale and leaseback arrangement. Instead, we recommend that a seller-lessee:

      (i) should account for the leaseback in the same manner as any other finance lease that is ongoing at the date of initial application (ie was previously accounted for under IAS 17 and continues to be in place at the date of initial application); and

      (ii) should continue amortising any gain on sale in the same manner as under IAS 17.

   (c) that, with respect to sale and leaseback transactions that were classified as operating leases under IAS 17, a seller-lessee should not perform any retrospective accounting specific to the sale and leaseback arrangement. Instead, we recommend that a seller-lessee should account for:

(i) the leaseback in the same manner as any other operating lease that is ongoing at the date of initial application (as described in Agenda Paper 3A);

(ii) any deferred losses that relate to off-market terms at the date of initial application as an adjustment to the leaseback ROU asset;

(iii) any deferred gains that relate to off-market terms at the date of initial application as an adjustment to the lease liability.

(d) that a seller-lessee is required to apply the partial gain recognition approach only to new sale and leaseback transactions entered into after the date of initial application.

Background

Existing IFRS (IAS 17)

6. 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 recognises 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 recognise any excess of sales proceeds over the carrying amount as income at contract inception. Instead any gain is deferred and amortised over the lease term;

(c) when sale and leaseback transactions include off-market terms, the gain or loss is effectively adjusted to reflect fair value.

New leases standard

7. The IASB discussed the accounting for sale and leaseback transactions at their July 2014 board meeting. At that meeting, the IASB made the following tentative decisions:

(a) in order for a sale to occur within the context of a sale and leaseback transaction, it must meet the requirements for a sale in IFRS 15. The presence of a leaseback does not, in isolation, preclude the existence of a sale. If the seller-lessee has a substantive repurchase option with respect to the underlying asset, then no sale has occurred;

(b) a buyer-lessor should account for the purchase of the underlying asset consistently with the guidance that would apply to any other purchase of a non-financial asset;

(c) a seller-lessee should account for any gain or loss on a completed sale in a sale and leaseback transaction consistently with the guidance that would apply to any other similar sale. However, any gain recognised should be restricted to the amount of the gain that relates to the buyer-lessor's residual interest in the underlying asset at the end of the leaseback;

(d) if a sale is completed, the seller-lessee and the buyer-lessor should account for the leaseback in the same manner as for any other lease;

(e) an entity should take account of off market terms. An entity should account for:

    (i) any deficiency in the same manner as a prepayment of rent; and

    (ii) any excess as additional financing provided by the buyer-lessor to the seller-lessee;

(f) a seller-lessee and a buyer-lessor should account for a sale and leaseback transaction that does not meet the requirements of IFRS 15 as a financing transaction.

Transition proposals in the 2013 ED

8. The 2013 ED proposed that an entity should reassess historic sale and leaseback transactions to determine whether a sale occurred in accordance with IFRS 15 if:

(a) the transaction was accounted for as a sale and operating lease in accordance with IAS 17; or

(b) the transaction was assessed to determine whether it was a sale and leaseback transaction in accordance with IAS 17, but it did not qualify for sale and leaseback accounting.

9. If the transaction satisfied the sale requirements in IFRS 15, the 2013 ED proposed that an entity should measure lease assets and lease liabilities at the date of transition and derecognise any deferred gain or loss.

10. With respect to historic sale and leaseback transactions that were accounted for as a sale and finance leaseback, the 2013 ED proposed that an entity:

(a) should not reassess the transaction to determine whether a sale occurred;

(b) should not remeasure lease assets and lease liabilities; and

(c) should continue to amortise any deferred gain or loss.

Feedback Received on the 2013 ED

11. Many constituents expressed concerns about the transition of existing sale and leaseback transactions. In particular, they expressed concerns 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 recognised 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 had concerns about the proposal to recognise deferred gains as an adjustment to equity at transition. This would result in those gains never being recognised in profit or loss.

12. Many of these constituents recommended grandfathering existing sale and leaseback transactions and applying the proposed guidance for sale and leaseback

transactions prospectively (ie only to sale and leasebacks entered into following application of the new leases standard).

Staff Analysis – Seller-Lessee

Overview

13. In Agenda Paper 3A, the staff recommend that a lessee should not be required to restate comparative figures on transition to the new leases standard. Instead, the staff recommend a cumulative catch up transition method under which the cumulative effect of applying the new leases standard is recognised as an adjustment to the opening balance of retained earnings (or other component of equity) at the beginning of the annual reporting period that includes the date of initial application. Nonetheless, it is still necessary to consider whether and how a seller-lessee would retrospectively reassess historic sale and leaseback transactions. This is because the results of any reassessment would influence the cumulative catch up transition adjustment recognised at the date of initial application.

14. The staff have considered the transition approach for historic sale and leaseback transactions separately for those that were classified as finance leasebacks under IAS 17 and those that were classified as operating leasebacks under IAS 17.

IAS 17 Sale and finance leasebacks

15. IFRS 15 states that a sale occurs when the seller transfers a promised good (in this case, the underlying asset) to a customer (in this case, the buyer-lessor). The sale occurs when the buyer-lessor obtains control of the asset. Conversely, if the buyer-lessor does not obtain control, then the transaction would not satisfy these requirements of IFRS 15 and should not be accounted for as a sale.

16. The staff think that the IASB 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 at contract inception based on IFRS 15. Some constituents have expressed the view that making this reassessment would incur a significant amount of time and cost.

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 IFRS 15.

17. With respect to sale and finance leaseback transactions, under the existing requirements of IAS 17, the seller-lessee does not immediately recognise any excess of sales proceeds over the carrying amount of the underlying asset. Instead, it is deferred and amortised over the lease term. This treatment affects reported information in a similar way to accounting for the transaction as a financing transaction. In other words, for historic sale and leaseback transactions that an entity accounted for as a finance lease under IAS 17, the outcome of requiring reassessment of whether a sale occurred under IFRS 15 would not be significantly different from not requiring such reassessment. The staff think that the costs of retrospective reassessment as to whether a historic sale and finance leaseback transaction would qualify as a sale under IFRS 15 would not be justified.

18. Consequently, the staff think that a seller-lessee should not be required to retrospectively reassess whether a transaction would have qualified as a sale at contract inception based on IFRS 15.

19. Under the requirements of the new leases standard, the seller-lessee is required to recognise the element of any gain on sale that relates to the residual asset when the asset is sold. This is different from accounting for the transaction under IAS 17 which requires the seller-lessee to defer and amortise the entire gain over the lease term. Accounting for this difference on transition to the new leases standard would be complex. This is because a seller-lessee would be required to retrospectively revisit each historic sale and finance leaseback transaction and assess the amount of the gain on sale that related to the residual asset.

20. The staff think that, for any sale and leaseback arrangement that was classified as a finance lease under IAS 17, the element of any gain on sale that relates to the residual asset would be small. A finance lease under IAS 17 is a contract for which substantially all of the risks and rewards incidental to ownership of the underlying asset are transferred to the lessee. Consequently, the residual asset

associated with any former finance lease would be expected to be relatively small, as would the element of any gain on sale that relates to this residual asset.

21. Consequently, the staff think that there would be little difference in terms of reported information arising from the retrospective reassessment of historic sale and finance leaseback transactions and from no reassessment of such transactions, and yet retrospective reassessment would increase complexity.

22. The staff therefore recommend that the new leases standard require a seller-lessee to not retrospectively account for sale and leaseback transactions that were classified as finance leases under IAS 17. Instead, we recommend that a lessee should continue amortising any gain on sale in the same manner as under existing guidance.

IAS 17 Sale and operating leasebacks

23. The staff think that, in most instances, transactions that an entity previously accounted for as sale and operating leaseback transactions would continue to qualify as a sale under IFRS 15. The only historic sale and operating leaseback transactions that we would expect *not* to qualify as a sale under IFRS 15 are those that contain a repurchase option.

24. Nonetheless, if retrospective reassessment does indicate that a historic sale and operating leaseback transaction would not qualify as a sale under IFRS 15, this could have potentially material accounting consequences. This is because IAS 17 requires a seller-lessee to recognise any gain or loss at contract inception in a sale and operating leaseback transaction (adjusted for any off-market terms). If the transaction did not constitute a sale, the seller-lessee would need to include the effect of eliminating this gain or loss in the cumulative catch up adjustment on transition. This adjustment would affect the opening balance of equity in the period of initial application and the value of the asset recognised on transition. The financial liability recognised on the date of initial application would not be affected.

25. On balance, the staff do not think that the costs associated with reassessment would be justified. This is because we think that re-assessment would only rarely lead to the conclusion that the transaction did not qualify as a sale under IFRS 15.

Consequently, we recommend that the new leases standard does not require a lessee to reassess historic sale and leaseback transactions to determine whether a sale occurred in accordance with IFRS 15.

26. According to IAS 17, when accounting for any historic sale and operating leaseback transactions, a seller-lessee would have recognised a profit or loss on sale of the underlying asset (adjusted for any off market terms) at contract inception. Under the new leases standard, a seller-lessee would account for the same transaction by restricting the gain recognised at contract commencement to the amount that relates to the buyer-lessor's residual interest in the underlying asset at the end of the leaseback.

27. Retrospective reassessment of this arrangement would be complex. This is because a seller-lessee would need to retrospectively revisit each historic sale and operating leaseback. For each transaction, the seller-lessee would be required to:

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

    (b) "unwind" the previous gain that was recognised on the initial sale;

    (c) "unwind" any previous accounting for off-market terms;

    (d) recognise a partial gain at the date of sale;

    (e) recognise the deferred portion of the gain over the leaseback term;

    (f) recognise any adjustments for off-market terms on the basis of the partial gain recognised.

28. The staff recommend, that the new leases standard provides a simplified transition method that does *not* require any retrospective reassessment of historic sale and operating leaseback transactions. Instead, a lessee would be required to transition an operating leaseback in the same manner as any other operating lease that is ongoing at the date of initial application (as described in Agenda Paper 3A). Consequently, there would be no adjustment to any amounts of gains or losses previously recognised on existing sale and operating leaseback transactions.

29. In addition, the staff think that any amounts that were previously deferred as a result of off-market terms should remain on transition to the new leases standard. This is because these amounts reflect continued financing that is unaffected by the

transition to the new leases standard and should continue to affect the seller-lessee's ongoing lease expense. The staff recommend that a seller-lessee should account for these amounts at the date of initial application as follows:

(a) for deferred losses that relate to off-market terms, as an adjustment to the leaseback ROU asset; or

(b) for deferred gains that relate to off-market terms, as an adjustment to the lease liability.

30. 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 date of initial application of the new leases standard. The staff are recommending this simplified approach for cost and complexity reasons. We acknowledge that retrospectively applying the partial gain recognition approach to historic sale and operating leaseback transactions *could* have a material effect on the seller-lessee's balance sheet and income statement. However, the staff think that the costs of applying a retrospective approach would outweigh the benefits in terms of reported information.

Staff Analysis – Buyer-Lessor

31. The staff recommend that the new leases standard does not require a buyer-lessor to reassess historic sale and leaseback transactions to determine whether a purchase has occurred in accordance with IFRS 15. This is for the same reasons as discussed above with respect to a seller-lessee.

32. The staff do not think that any further transition requirements are necessary with respect to buyer-lessors in the new leases standard. This is because the IASB previously decided to substantially retain the existing lessor accounting model. Therefore, if not required to reassess whether a purchase of the asset has occurred, there would be no change in the accounting applied by a buyer-lessor under the new leases standard as compared with IAS 17.

Staff Recommendations and Questions for the IASB

Questions: Transition – Sale and Leaseback Transactions

1. Does the IASB agree with the staff recommendation to not require reassessment of historic sale and leaseback transactions to determine whether a sale occurred in accordance with IFRS 15?

2. Does the IASB agree with the staff recommendation that, with respect to sale and leaseback transactions that were classified as finance leases under IAS 17, a seller-lessee should not be required to perform any retrospective accounting specific to the sale and leaseback arrangement? Instead, a seller-lessee would be required to:

   (a) account for the leaseback on transition in the same manner as any other finance lease that is ongoing at the date of initial application; and

   (b) continue amortising any gain on sale in the same manner as under IAS 17.

3. Does the IASB agree with the staff recommendation that, with respect to sale and leaseback transactions that were classified as operating leases under IAS 17, a seller-lessee should not perform any retrospective accounting specific to the sale and leaseback arrangement? Instead a seller-lessee would be required to:

   (a) account for the leaseback on transition in the same manner as any other operating lease that is ongoing at the date of initial application (as described in Agenda Paper 3A);

   (b) account for any deferred losses that relate to off-market terms at the date of initial application as an adjustment to the leaseback ROU asset; and

   (c) account for any deferred gains that relate to off-market terms as an adjustment to the lease liability.

4. Does the IASB agree with the staff recommendation to require a seller-lessee to apply the partial gain recognition approach only to new sale and leaseback transactions entered into after the date of initial application?