Lease & Finance Accountants Conference

September 11-13 ▪ The Westin Charlotte ▪ Charlotte, NC

HANDOUTS

ELFA
EQUIPMENT LEASING AND FINANCE ASSOCIATION

Sale and leaseback transactions

Lease and Finance Accountants Conference
Charlotte
September 11-13, 2017

Presenters

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What is a sale and leaseback transaction?

- A transaction that involves
  - the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor); and
  - the leaseback of the same asset by the seller-lessee

Major changes at a glance

Scope

- The new sale and leaseback accounting model applies to
  - All assets within the scope of ASC 842 (different models for real estate and equipment eliminated)
  - Both buyer-lessor and seller-lessee (symmetrical model)

The new model

- Determine if a sale has occurred
  - Seller-lessee and buyer-lessor may reach different conclusions
- Gain for "good" sale and leaseback not deferred but recognized at the time of sale (adjusted for off-market terms)

Impact

- No longer a source of off-balance sheet accounting for the seller-lessee
- Achieving sale and leaseback accounting may become easier for real estate but harder for equipment
- "Failed" sale and leaseback accounting will be accounted for as a borrowing by the seller-lessee and lending by the buyer-lessor

Transition

- Existing "good" sale and leaseback accounting grandfathered
- Existing "failed" sale and leaseback reassessed under the new model
- Leaseback is accounted for under lessee and lessor transition requirements

The new sale and leaseback accounting model

Determine whether a sale has occurred

- Seller-lessee and buyer-lessor accounting is symmetrical
- Transaction must qualify as a sale under new revenue guidance
  - Is there a contract between the would be buyer-lessor and would be seller-lessee?
  - Has control of the underlying asset transferred from the would be seller-lessee to the would be buyer-lessor?
- No sale is recognized when the leaseback is classified as a finance lease or a sales-type lease
- A repurchase option may prevent sale accounting
- Failure to qualify for sale and leaseback accounting results in accounting the transaction as financing by both parties to the transaction

The new sale and leaseback accounting model (contd.)

Existence of a contract under the new revenue model

- The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations
- The entity can identify each party's rights regarding the goods or services to be transferred
- The entity can identify the payment terms for the goods or services to be transferred
- The contract has commercial substance (i.e., the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract)
- It is probable that the entity will collect the consideration it is entitled to in exchange for the goods or services it will transfer to the customer

The new sale and leaseback accounting model (contd.)

Transfer of control indicators under the new revenue model

- The reporting entity (would be seller-lessee) has a present right to payment
- The customer (would be buyer-lessor) has legal title
- The customer (would be buyer-lessor) has physical possession
- The customer (would be buyer-lessor) has the significant risks and rewards of ownership
- The customer (would be buyer-lessor) has accepted the asset

The new sale and leaseback accounting model (contd.)

Repurchase option

- In the new revenue standard, sale recognition is precluded when
  - The seller-lessee has a substantive repurchase right (call option); or
  - The seller-lessee is obligated to repurchase the underlying asset (forward); or
  - The seller-lessee is obligated to repurchase the underlying asset at the buyer-lessor's request at a lower than original selling price and the buyer-lessor has a significant economic incentive to exercise that right
- However, a repurchase option does not preclude sale and leaseback accounting if:
  - Substantially the same alternative underlying asset is readily available in the market; and
  - The repurchase option is at the then fair value at the time of exercise

The new sale and leaseback accounting model (contd.)

Accounting for "good" sale and leaseback by seller-lessee

- Recognize transaction price in accordance with the new revenue standard
- Derecognize carrying amount of underlying asset
- Account for lease in accordance with the new leases guidance

Accounting for "good" sale and leaseback by buyer-lessor

- Account for purchase in accordance with other GAAP
- Account for lease in accordance with the new leases standard

The new sale and leaseback accounting model (contd.)

Accounting for off-market terms

- Determine whether transaction is at fair value based on the difference between whichever is more readily determinable:
  - Sale price of asset and fair value of asset
  - Present value of lease payments and present value of market rental payments
- If not at fair value, adjust sale price:
  - Any increase to the sales price as prepayment of rent
  - Any reduction in sales price as additional financing provided by buyer-lessor to seller-lessee
- Not off-market solely because the sale price or the lease payments include a variable component
- Adjustment to sale price does not apply to related party leases

The new sale and leaseback accounting model (contd.)

Accounting for “failed” sale and leaseback by seller-lessee

- Continue to recognize carrying amount of underlying asset
- Account for amounts received as financial liability in accordance with other GAAP
- Adjust the interest rate to ensure
  - Interest on financial liability is not greater than principal payments on financial liability over shorter of lease term and term of financing
  - Carrying amount of asset does not exceed carrying amount of financial liability at earlier of end of lease term or date at which control will transfer to buyer-lessor

Accounting for “failed” sale and leaseback by buyer-lessor

- Do not recognize transferred asset
- Account for amounts paid as receivable in accordance with other GAAP

Transition for sale and leaseback transactions

- If a transaction previously qualified for sale-leaseback accounting, no reassessment is required
- If a transaction previously "failed" sale-leaseback accounting and remains a "failed" sale at effective date of the new leases standard, reassess whether a sale would have occurred during the lookback period under the new rules
    - If yes, account for the transaction on a modified retrospective basis from the date of the deemed sale
- Account for leaseback per lessee transition requirements
- For a sale and operating leaseback under ASC 840, recognize any deferred gain or loss (not from off-market terms) as a cumulative-effect at the later of the date of initial application to equity or the date of sale to earnings of the comparative period presented

Some FAQs

- Does a residual value guarantee from the seller-lessee to the buyer-lessor preclude sale and leaseback accounting?
- Do sale and leaseback provisions apply to the sale and leaseback of an asset that is subject to an operating lease or is subleased or intended to be subleased by the seller-lessee to another party under an operating lease?
- Must lessors apply sale and leaseback transition guidance under the new leases standard to failed sale and leaseback transactions under ASC 840 that existed prior to the effective date of the new leases standard?
- Must lessees apply sale and leaseback transition guidance under the new leases standard to failed sale and leaseback transactions under ASC 840 that existed prior to the effective date of the new leases standard when such failed sale and leaseback transactions resulted from failed build-to-suit transactions under ASC 840?
- Is there a way to achieve sale and leaseback accounting for sale and leaseback of equipment with a fixed price purchase option held by the seller-lessee?

Appendix

Illustrative example – good SLB*

Facts

- Seller sells land to an unrelated buyer for cash of $2M
- Carrying value of land is $1M and its fair value is $1.4M
- Seller simultaneously leases back the land for 10 years for $120,000 annual rent in arrears
- Seller's incremental borrowing rate is 6%
- Buyer's applicable discount rate 6%
- Leaseback is an operating lease
- The transaction qualifies as a sale
- Ignore initial direct costs

*ASC 842-40-55-23 through 55-30

Seller-lessee accounting at commencement

	Dr.	Cr.
Dr. Cash	$2,000,000	
Cr. Land		$1,000,000
Cr. Financing liability		$600,000
Cr. Gain on sale		$400,000
Dr. ROU asset	$283,210*	
Cr. Lease liability		$283,210

*Annual payment split between servicing additional financing liability and assumed market rent. $283,210 is present value of rent not attributable to servicing of additional financing liability ($120,000 - $81,521 = $38,479) at 6%. $81,521 is the amount of each $120,000 annual payment that must be attributed to servicing the financial liability for that financial liability to reduce to zero by the end of the lease term.

Illustrative example – good SLB (con.)

Facts

- Seller sells land to an unrelated buyer for cash of $2M
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Seller-lessee accounting at end of Year 1

Dr. Interest expense	$36,000*	
Cr. Financing liability		$36,000
Dr. Financing liability	$81,521*	
Dr. Lease liability	$21,486**	
Dr. Lease expense	$38,479	
Cr. ROU asset		$21,486***
Cr. Cash		$120,000

*On financing liability

**Increase for imputed interest on lease liability (6% x $283,210 = $16,993), reduce for portion of payment related to market rentals ($38,479)

*** Plug ($38,479 - $16,993)

Illustrative example – good SLB (con.)

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- Buyer's applicable discount rate 6%
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Buyer-lessor accounting at commencement

Dr. Land	$1,400,000	
Dr. Financing receivable	600,000	
Cr. Cash		$2,000,000

Buyer-lessor accounting at the end of Year 1

Dr. Cash	$120,000	
Cr. Financing receivable		$45,521*
Cr. Lease income		$38,479
Cr. Interest income		$36,000

*Increase of $36,000 for interest income, less portion of payment allocated to additional financing of $81,521

Illustrative example – failed SLB*

Facts

- Seller sells an asset to an unrelated buyer for cash of $2M
- Carrying value of the asset is $1.8M and remaining useful life is 21 years
- Seller simultaneously leases back the asset for 8 years with annual payments of $200,000 in arrears
- Seller has a repurchase option at the end of year 5 for $800,000
- Seller's incremental borrowing rate is 4%
- Buyer's applicable discount rate is 4%
- Existence of fixed price repurchase option precludes sale accounting

Seller-lessee accounting at commencement

Dr. Cash	$2,000,000	
Cr. Financing liability		$2,000,000

Buyer-lessor accounting at commencement

Dr. Financing receivable	$2,000,000	
Cr. Cash		2,000,000

*ASC 842-40-55-31 through 55-38

Illustrative example – failed SLB (con)

Facts

- Seller sells an asset to an unrelated buyer for cash of $2M
- Carrying value of the asset is $1.8M and remaining useful life is 21 years
- Seller simultaneously leases back the asset for 8 years with annual payments of $200,000 in arrears
- Seller has a repurchase option at the end of year 5 for $800,000
- Seller's incremental borrowing rate is 4%
- Buyer's applicable discount rate is 4%
- Existence of fixed price repurchase option precludes sale accounting

Seller-lessee accounting at the end of Year 1

Dr. Interest expense	$84,600*	
Dr. Financing liability	$115,400	
Cr. Cash		$200,000
Dr. Depreciation expense	$85,714**	
Cr. Accumulated depr.		$85,714

*Imputed interest rate of 4.23% so that there is no negative amortization of the financial liability and there is no built in loss at end of year 5 when repurchase option expires.

** Asset continues to depreciate over remaining life of 21 years

Illustrative example – failed SLB (con)

Facts

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- Seller's incremental borrowing rate is 4%
- Buyer's applicable discount rate is 4%
- Existence of fixed price repurchase option precludes sale accounting

Buyer-lessor accounting at the end of Year 1

Dr. Cash	$200,000	
Cr. Financing receivable		$120,000
Cr. Interest income		$80,000*

*Buyer continues to use 4% rate to recognize interest expense

Illustrative example – failed SLB (con)

Facts at the end of Year 5

- Repurchase option expires unexercised
- No other factor precludes sales accounting treatment
- Leaseback classified as operating lease
- Seller-lessee derecognizes asset and financing liability, recognizes ROU asset and lease liability
- Buyer-lessor derecognizes lease receivable, recognizes asset

Seller-lessee accounting at the end of Year 5

Dr.	Financing liability	$1,372,077	
	Cr. Asset		$1,371,429
	Cr. Gain on sale		$648
Dr.	ROU asset	$555,018	
	Cr. Lease liability		$555,018*

*Present value of $200,000 annual lease payments for remaining 3 year lease term discounted at lessee's incremental borrowing rate upon sale recognition assumed to be 4%

Buyer-lessor accounting at the end of Year 5

Dr.	Asset	$1,350,041	
	Cr. Financing receivable		$1,350,041

Thank you