Boards Meet to Consider Sale Leaseback Accounting

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The International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) met on July 23, 2014, to continue deliberations on changing accounting standards governing lease transactions. Specifically, they considered sale leaseback (SLB), lessor disclosure, and related accounting issues.

The SLB discussion resulted in another possible major disagreement between the FASB and IASB. The disagreement centered on SLBs with non-bargain purchase options.

Transfer of "control" of the asset is the basis for determining sale treatment under the new Revenue Recognition (Rev Rec) standard, while transfer of "risks and rewards" in the asset is the basis for determining whether a lease is a financed purchase or a lease/rental. Per Rev Rec, the presence of a purchase option (PO) at **<u>any</u>** price means the seller/lessee still retains an element of control over the asset. The staff proposed that a SLB be considered a combined contract with "sale leg" of the SLB judged vs. Rev Rec. and that the Rev Rec rules override Lease rules in determining the accounting treatment of the SLB combined contract. As such, the presence of **<u>any</u>** purchase option (PO) in the leaseback negates sale treatment. Per Rev Rec, if there is no sale in the SLB, the transaction is a "failed" SLB and must be accounted for as a financing.

The FASB is doubtful about this result. It has decided to direct the staff to do more work on "failed" SLB accounting, as the proposed accounting for the transaction as a financing results in the asset reflected on the seller lessee's books not being representative of the retained rights in the leased asset and the liability not being representative of the lease obligations. The asset would be the whole asset "sold" and leased back. The liability would either:

1. Include the PO as a balloon and use the resulting implicit rate to impute interest (the implicit rate would be higher than the lessee's incremental borrowing rate),
2. Exclude the PO and use the resulting implicit rate to impute interest (the implicit rate would be much lower than the lessee's incremental borrowing rate – often negative), or
3. Use the lessee's incremental borrowing rate to impute interest. This will cause negative amortization such that there will be a balloon at the end of the lease term that will have no relation to anything.

The FASB also questioned the notion that a non-bargain PO should negate sale treatment as under the Leases project's risk and rewards principle, a non-bargain PO would not negate Type B (current operating) lease treatment.

Official notes from the FASB website DECISIONS REACHED AT THE LAST MEETING (July 23, 2014) (with key items in "bold" type added):

The Boards continued redeliberating the proposals in the May 2013 Exposure Draft, Leases, specifically discussing the following topics: (1) sale and leaseback transactions and (2) lessor disclosure requirements.

<u>Sale and Leaseback Transactions</u>

Determining Whether a Sale Has Occurred

The Boards decided to retain the guidance in the 2013 Exposure Draft 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 recently issued revenue recognition standard. The Boards reaffirmed that the presence of the leaseback does not, in isolation, preclude the seller-lessee from concluding that it has sold the underlying asset to the buyer-lessor.

The FASB decided that if the seller-lessee determines that the leaseback is a Type A lease, assessed from the seller-lessee's perspective, then no sale has occurred.

The FASB decided to further evaluate (1) whether to include additional application guidance in the final Leases standard regarding the determination of the sale and (2) the effect of repurchase options on sale and leaseback transactions, particularly call options exercisable at fair value.

The IASB decided not to include any additional application guidance in the final leases standard regarding the determination of the sale. The IASB clarified, however, that if the seller-lessee has a substantive repurchase option with respect to the underlying asset, then no sale has occurred.

Accounting for the Sale/Purchase

The Boards decided to retain the guidance in the 2013 Exposure Draft that a buyer-lessor should account for the purchase of the underlying asset consistent with the guidance that would apply to any other purchase of a nonfinancial asset (that is, without the presence of the leaseback).

The Boards decided to retain the guidance in the 2013 Exposure Draft that a seller-lessee should account for any loss on a completed sale in a sale and leaseback transaction consistent with the guidance that would apply to any other similar sale.

The FASB decided to retain the guidance in the 2013 Exposure Draft that a seller-lessee should account for any gain on a completed sale in a sale and leaseback transaction consistent with the guidance that would apply to any other similar sale.

The IASB decided that the gain recognized by a seller-lessee on a completed sale in a sale and leaseback transaction should be restricted to the amount of the gain that relates to the residual interest in the underlying asset at the end of the leaseback.

Accounting for the Leaseback

The Boards decided to retain the guidance in the 2013 Exposure Draft that if a sale is completed, the seller-lessee and the buyer-lessor should account for the leaseback in the same manner as any other lease.

Accounting for "Off-Market" Terms

The Boards decided that an entity should determine any potential "off-market" adjustment on the basis of the difference between either (1) the sale price and the fair value of the underlying asset or (2) the present value of the contractual lease payments and the present value of fair market value lease payments, whichever is more readily determinable.

For sale and leaseback transactions entered into at "off-market" terms, the Boards decided that an entity should account for:

1. Any *deficiency* in the same manner as a prepayment of rent.
2. Any *excess* as additional financing provided by the buyer-lessor to the seller-lessee.

Accounting for Failed Sale and Leaseback Transactions

The FASB decided to perform additional analysis on the accounting that should apply to "failed" sale and leaseback transactions.

The IASB decided to retain the guidance proposed in the 2013 Exposure Draft that both a seller-lessee and a buyer-lessor would account for a "failed" sale and leaseback transaction as a financing transaction.

<u>Lessor Disclosure Requirements</u>

The Boards decided that a lessor should be required to disclose:

1. Information about the nature of its leases, as well as information about significant assumptions and judgments made in applying the leases requirements;
2. A table of lease income during the reporting period; and
3. Information about how a lessor manages its risk associated with the residual value of its leased assets.

The Boards decided that a lessor should treat assets subject to Type B leases as a class of property, plant, and equipment (IFRS) or a major class of depreciable assets (U.S. GAAP), further distinguished by significant class of underlying asset. Accordingly, a lessor should provide the required property, plant, and equipment disclosures for assets subject to Type B leases separately from owned assets held and used by the lessor.

The Boards also decided that a lessor should be required to disclose:

1. For Type A leases, a maturity analysis of the undiscounted cash flows that comprise the lessor's lease receivables for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter. A lessor should reconcile the maturity analysis to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes; and
2. For Type B leases, a maturity analysis of the undiscounted future lease payments to be received for each of the first five years following the reporting date and a total of the amount for the remaining years thereafter.

The FASB decided that a lessor should be required to provide an explanation of the significant changes in the components of the net investment in Type A leases other than the lease receivable during the reporting period. The FASB will consider disclosures related to Type A lease receivables when it discusses disclosures in its project on accounting for financial instruments—credit impairment.

The IASB decided that a lessor should be required to provide a qualitative and quantitative explanation of the significant changes in the net investment in Type A leases during the reporting period.