An Analysis of the New Sale and Leaseback Guidance

By Josef Rashty

In February 2016, FASB issued Accounting Standards Update (ASU) 2016-02, *Leases* (*Topic 842)*. Topic 842 will supersede the existing lease guidance (Topic 840), which has been in effect since 1977. ASU 2016-02 will become effective for public companies for fiscal years (and interim periods within those fiscal years) beginning after December 15, 2018. For private companies, the standard will become effective for fiscal years beginning after December 15, 2019 (and interim periods beginning the following year). The standard permits early adoption and requires use of a modified retrospective transition method.

This article will provide a brief overview of lessor and lessee accounting, followed by a more detailed discussion and analysis of the sale and leaseback provisions in ASC Topic 842. Although some transactions can easily be identified as sale and leaseback transactions (SLB), classification of certain other arrangements may pose challenges for companies. Bona fide sale and leaseback transactions must meet the sale criteria under Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers,* and the leaseback criteria under ASC 842.

Lessor Accounting

Lessors classify lease transactions as operating leases, sales-type leases, or direct financing leases. This classification is determined based on whether the lease agreement transfers substantially all of the risks and rewards of ownership of the underlying asset from the lessors to the lessee.

In a sales-type lease transaction, lessors derecognize the leased asset and recognize their net investment in the lease. In summary, the lessor will record lease payments receivable for their present values at the commencement date of the lease payments, plus the present value of any unguaranteed residual asset value at the end of the lease term (ASC 842-30-30-1).

Lessors calculate and recognize any selling profit or loss at the commencement of the lease as the fair value of the underlying asset (or the sum of lease receivable and any prepaid lease payment by lessee, if lower), less the carrying amount of the underlying asset net of any unguaranteed residual asset, less any deferred initial direct costs of the lessor.

Lessors can recognize profit upfront if and only if lessees have obtained control of the lease item.

In direct financing arrangements, lessors, consistent with ASC 606 and unlike with sales-type leases, do not recognize any selling profit at the commencement of the lease because the arrangement does not transfer control of the underlying asset to lessees. When a lessor transfers the ownership but not the control of an asset to a lessee, it has effectively converted the risk arising from the ownership of an underlying asset into a credit risk.

In direct financing leases, lessors derecognize the leased asset and record a net investment in the same manner as sales-type leases (ASC 842-30-30-2); however, lessors do not recognize any selling profit upfront, but defer and recognize such profit ratably (using the effective interest rate method) through the life of the contract.

In operating leases—unlike sales-type and direct financing leases—lessors keep the underlying assets on their balance sheets and depreciate them during their useful lives. Rental revenues are recognized on a straight-line basis (or any other systematic basis, as appropriate). Ownership and control of the leased items remain with lessors.

Exhibit 1 summarizes the three different methods of lessor accounting in a typical lease agreement.

Exhibit 1
A Summary of the Three Methods of Lessor Accounting

Sales-Type Leases	Direct Financing Leases	Operating Leases
Lessor derecognizes the underlying asset and immediately recognizes any profit (loss).	The same as sales-type leases, but lessor defers recognition of any profit.	Lessor maintains the underlying asset in its balance sheet and depreciates it over its useful life.
Lessor recognizes net investment in its balance sheet for sum of the present value of the future lease payments and unguaranteed residual value.	The same as sales-type leases.	Lessor presents lease revenues and expenses on a gross basis in its income statement.
Lessor increases the net investment by interest income and decreases it by payments collected.	The same as sales-type leases.	
Lessor transfers control of the asset to lessee. Thus, it can recognize sale profits and losses at the outset.	Lessor does not transfer control of the asset to lessee. Thus, it defers any sale profits but recognizes sale losses at the outset.	
Lessor reflects any interest income in net investment based on the effective interest rate in the lease.	The same as sales-type leases.	

Lessee Accounting

Lessees recognize a right-of-use (ROU) asset and a lease liability on their balance sheets for virtually all lease obligations (with the exception of short-term leases, i.e., those with duration of 12 months or less).

FASB has adopted a dual model of lessee accounting that permits lessees to classify leases either as operating or finance leases—a different approach than the single-model one adopted by the IASB. Finance leases under the new Topic 842 are categorically no different than capital leases under the prior guidance in Topic 840. Operating leases reflect lease expense on a straight-line basis (similar to operating leases under prior guidance); however, finance leases result in a front-loaded lease expense (similar to current capital leases under prior guidance).

Sale and Leaseback Transactions

In an SLB transaction, a seller-lessee sells one of its assets to a buyer-lessor in exchange for consideration and makes periodic rental payments to the buyer-lessor in exchange for retaining the use of the asset. Because ASC 842 requires lessees to rec-

Exhibit 2 Annual Lease Payments from Seller-lessee's Perspective ($ in millions)			
Period	**Payment**	**Interest**	**Principal***
First year	$100	$18	$82
Second year	$100	$13	$87
Third year	$100	$7	$93
Total	$300	$38	$262

*Present value of lease payments.

ognize most leases (with the exception of short-term leases) on their balance sheets, SLB transactions no longer provide seller-lessees with off–balance sheet financing. As a result, SLB transactions have lost some of their appeal for seller-lessees, but nevertheless remain attractive for other reasons.

The benefits of SLB transactions are as follows:

- Generate cash flows for the seller-lessee
- Represent an alternative and more effective financing for the seller-lessee
- Transfer the tax ownership and related benefits to the buyer-lessors
- Strengthen the balance sheet of the seller-lessee by reflecting a lower amount of financing.

ASC 840 applied SLB transactions only to lessees and included a detailed and specialized guidance for real estate SLB transactions; however, ASC 842 applies SLB transactions to both lessees and lessors and does not have any specialized guidance for real estate SLB transactions.

FASB requires that transactions meet certain criteria to qualify as SLB transactions, as described below.

Sale criteria. In SLB transactions, the sale should comply with the provisions of ASC Topic 606. "Revenues from Contracts with Customers." Topic 842 aligns lessee and lessor accounting in several key respects with the provisions of revenue recognition guidance in Topic 606, and does not differentiate between leases of real estate and leases of other assets.

Seller-lessees can account for the transfer of assets as a sale if the following two conditions exist (ASC 842-40-25-1):

- A contract exists, based on ASC 606-10-25-1 through 25-8
- The seller-lessee satisfies its performance obligation by transferring control of assets to the buyer-lessor (ASC 606-10-25-30).

Sale of assets by seller-lessees implies that buyer-lessors (or the customers) have obtained control of assets. If the transaction fails as a sale, it also fails as a SLB transaction. In a bona fide SLB transaction, a seller-lessee recognizes the full amount of the gain from a SLB transaction (ASC 842-40-25-1).

If the leaseback phase of a SLB transaction fails, the buyer-lessor classifies the transaction as a sales-type or direct financing lease, and the seller-lessee classifies it as a finance lease (ASC 842-40-25-2).

Control criteria. If a seller-lessee controls the underlying asset—that is, it can direct its use and obtain substantially all of its remaining benefits—before transferring it to a buyer-lessor, the transaction may be classified as a SLB transaction if the other criteria have been satisfied (ASC 842-40-55-1). If, however, the seller-lessee does not obtain control of the underlying asset, even if it obtains the legal title, before transferring it to buyer-lessor, the transaction fails as a SLB transaction (ASC 842-40-55-2).

A buyer-lessor obtains control of an asset when a contract exists (ASC 606-10-25-1 through 25-8) and the seller-lessee has performed its obligations by transferring control of assets to the buyer-lessor. ASC Topic 606 identifies five indicators that a customer (in this case a buyer-lessor) has obtained control of an asset:

- Customer has legal title
- Customer has physical possession
- Customer has the significant risks and rewards of ownership
- Customer has accepted the asset
- Seller has a present right to payment.

The guidance presents the above as indicators rather than criteria, and not all indicators must be present to conclude that a buyer-lessor has control of the transferred asset. Clearly, these indicators have shifted judgment for transfer of control in SLB transactions to buyer-lessors.

Sale and Leaseback Accounting

SLB transactions also fail if the seller-lessee obtains control of the lease items or gives guarantees for their value in the leaseback phase of transaction. If control of an underlying asset is transferred to a seller-lessee in the leaseback phase of transaction, the SLB transaction fails: the seller-lessee classifies the transaction as a "finance lease," and the buyer-lessor classifies it as a "sales-type lease." If the control of the underlying asset is not effectively transferred to a seller-lessee, but the buyer-lessor obtains a guarantee for the value of the asset from the seller-lessee, the transaction also fails: the seller-lessee classifies the transaction as a finance lease, and the buyer-lessor classifies it as a "direct financing lease." Buyer-lessors and seller-lessees classify leaseback transactions that have not failed as "operating leases."

ASC 842-40-30-1 requires that seller-lessees and buyer-lessors record SLB transactions with off-market terms at fair value. Seller-lessees and buyer-lessors adjust the sale amount if it is not at fair value.

If a seller-lessee sells an asset and receives proceeds that are less than the fair value of the asset, it recognizes the difference as prepaid rent. If the sales proceeds are higher than the fair value of the asset, it recognizes the excess as additional borrowing (ASC 842-40-55-24).

If a buyer-lessor purchases an asset and makes payments that are less than the fair value of the asset, it recognizes the difference as additional financing. If the proceeds are higher than the fair value of the asset, it recognizes the excess as rent prepayment (ASC 842-40-30-2).

Rights to repurchase. A seller-lessee may have certain rights or obligations to repurchase goods sold to customers under the following conditions:

■ A seller-lessee may enter into a forward agreement if it has the obligation to repurchase the goods sold.

■ A seller-lessee may enter into a call option agreement if it has the right to repurchase the goods sold.

When a seller-lessee transfers certain goods with substantive forward or call option provisions, it limits the buyer-lessor's ability to control the goods it has received. Thus, accounting for SLB transactions with substantial repurchase rights and obligations depends on the likelihood that such rights or obligations will be exercised.

ASC 842-40-25-3 provides additional guidance on evaluating a repurchase option in SLB transactions. A repurchase option does not preclude sale accounting if both of the following criteria are met:

■ The seller-lessee can exercise the repurchase option at the then-prevailing fair value of the asset.

■ Alternative assets are readily available in the marketplace that are substantially the same as the underlying asset.

If a repurchase option or obligation precludes a seller-lessee from accounting for the transaction as a sale, the SLB transaction fails, and both the seller-lessee and the buyer-lessor account for the contract as a financing arrangement.

Rights to sell. A buyer-lessor's right to require the seller-lessee to repurchase the lease item is a put option. A put option creates an obligation (a forward) for the seller-lessee to repurchase the goods from the buyer-lessor. If the buyer-lessor's selling price (or seller-lessee's repurchase price) is lower than original selling price or the prevailing market value, the buyer-lessor most likely does not have significant economic incentive to exercise the put option. In such a transaction, the sale has a right of return within the scope of revenue recognition guidance, but the transaction does not necessarily fail as an SLB transaction. If the buyer-lessor's selling price (or seller-lessee's repurchase price) is higher than original selling price or the prevailing market value, then the buyer-lessor most likely

Exhibit 3 Annual Lease Payments from Buyer-lessor's Perspective ($ in millions)				
Period	**Receipt**	**Interest**	**Accretion of other Income**	**Reduction in Buyer/Lessor Investment***
First year	$100	$18	$7	$75
Second year	$100	$13	$7	$80
Third year	$100	$7	$8	$85
Total	$300	$38	$22	$240

*Present value of lease payments less accretion.

has significant economic incentive to exercise the put option. The transaction fails as a sale, and the leaseback transaction is a financing arrangement.

Sample Journal Entries

The following reflects the first-year journal entries of a seller-lessee and a buyer-lessor in a hypothetical SLB transaction. It does not encompass all the scenarios that are discussed above.

A seller-lessee sells an oil rig with a book value of $240 million to a buyer-lessor for the same price and immediately leases it back.

The following additional information is available:

- The lease payment is $100 million per year in arrears.
- The term of the leaseback is three years with no renewal.
- The incremental borrowing rate of the seller-lessee is 7%.
- The buyer-lessor's sales price is $262 million.
- The remaining life of the oil rig is three years.

Exhibit 2 reflects the payments per year from the seller-lessee's perspective; *Exhibit 3* reflects them from the buyer-lessor's perspective.

Seller/Lessee (in millions)

Initial sale journal entry

Cash	$240	
Oil rig		$240

First-year journal entries:

Operating lease

Right-of-use (ROU)	$262	
Lease liability		$262

Present value of lease payments

Lease expense	$100	
Cash		$100

Annual lease payments

Lease liability	$87	
ROU		$87

Depreciation of ROU and a corresponding reduction to ROU ($262 ÷ 3).

Financing lease

ROU	$262	
Lease liability		$262

Present value of lease payments

Amortization expense	$87	
ROU		$87

Depreciation of ROU and a corresponding reduction to ROU ($262 ÷ 3).

Finance charges	$18	
Lease liability	$82	
Cash		$100

Annual lease payment and its allocation to finance charges and lease liability

Buyer/Lessor (in millions)

First-year journal entries:

Operating lease

Cash	$100	
Lease income		$100

Lease payments received

Depreciation expense	$80	
Accumulated depreciation		$80

Depreciation of the asset leased

Sales-type lease

Lease receivable	$262	
Oil rig to be sold (leased)		$240
Other income		$22

Recognition of profit for asset sold (leased) as part of SLB transaction

Cash	$100	
Interest income		$18
Lease receivable		$82

Receipt of lease payment

Direct financing lease

Investment	$240	
Oil rig to be sold (leased)		$240

Asset sold (leased) and deferral in reco nition of $22 other income

Cash	$100	
Other income		$25
Investment		$75

Receipt of lease payment and recognition of interest and other income

Cutting through the Complexity

Determining whether a sale has occurred and the seller-lessee has transferred control to the buyer-lessor within the context of ASC Topic 606 and ASC Topic 842 is complicated and affects the initial and subsequent accounting treatment of SLB transactions. Furthermore, several other factors determine the proper accounting for the leaseback phase of an SLB transaction, such as repurchase provisions like call options, forward agreements, and put options.

Finally, ASC 842, like any other principles-based guidance, requires the exercise of significance judgment for its proper implementation and application. Accounting for SLB transactions is complex, and this article only explores some rudimentary concepts of these transactions. CPAs advising businesses that engage in such transactions would do well to study the full guidance and determine how it applies to their specific business activities. ❑

Josef Rashty, CPA, *is an adjunct professor of accounting at Golden Gate University in San Francisco, Calif. He can be reached at j_rashty@yahoo.com.*