Sale and Leaseback Arrangements –
Similar but With Different Accounting Consequences

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Structuring and Anti-Abuse Measures

Sale and leaseback transactions have not been popular with standard setters in the past and is still not well received today. **Structuring** to create a particular accounting outcome is the concern and the accounting for sale and leaseback transactions does appear to significantly feature anti-abuse measures.

I am a tennis fan and while watching the four hours replay of the epic 2023 Wimbledon five-set men's final, my mind wondered into the realm of sales and leaseback accounting. Did sale and leaseback incur a double fault for blurring the line? Are the standard setters at risk of a time violation?

Double Fault for blurring the line?

IASB acknowledged – Structuring concerns substantially reduced under IFRS 16

The International Accounting Standards Board ("IASB") in its basis for conclusion ("BC") acknowledged that some of the **structuring concerns** relating to sale and operating leaseback transactions that had existed under IAS 17 *Leases* would be **substantially reduced** by the lease accounting model in IFRS 16 *Leases*, which requires the recognition of lease assets and lease liabilities by the seller-lessee.

Seller-lessees are penalised twice

Notwithstanding the above, seller-lessees are penalised twice – (i) to only recognise a portion of the gain or loss from the sale of the asset (gain or loss that relates to the rights transferred to the buyer-lessor); and (ii) expanded lease measurement to include all variable lease payments.

Gain or Loss on Sale and Leaseback – IASB's view

IFRS 16 requires the seller-lessee to recognise only the amount of gain or loss that relates to the rights transferred to the buyer-lessor. In reaching this decision, the BC explained that the IASB considered requiring the sale element of the transaction (i.e the sale of the underlying asset) to be accounted for applying IFRS 15 because, from a legal standpoint, the seller-lessee will often have sold the entire underlying asset to the buyer-lessor.

Economic standpoint of view

However, IASB is of the view that from an economic standpoint, the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback – it has retained its right to use the asset for the duration of the leaseback. Hence the IASB concluded that recognising the gain that relates to the rights transferred to the buyer-lessor appropriately reflects the economics of the transaction.

Economic Substance of Sales and Leaseback Arrangements

Before dwelling further into the complexity of sale and leaseback accounting, lets first consider the economic substance of such arrangements.

Unlock capital from real estate assets owned

Companies seeking to unlock capital from real estate assets owned can either sell their real estates and separately enter into leasing transactions or enter into a sale and leaseback contract with the buyer-lessor. This raises additional capital without the need to dilute equity with capital raised from additional investors.

Sale and leaseback – benefits come with risks

Other benefits include access to liquidity, cashing in on upward property value gains and tax savings from deductibility of rental payments. These benefits however will need to be carefully weighed against operational uncertainties arising from the loss of ownership of the company's property, uncertainties in future rental rates and the foregoing of any future capital appreciation of the property.

What's in it for buyer-lessor?

The buyer-lessor on the other hand gains from ownership of an income-generating property and any future appreciation in the value of the property.

Should the seller-company enter into a leaseback contract or a separate lease contract?

From an economic consideration, seller-companies will typically choose leaseback transactions because they are in a stronger position to negotiate favourable terms with the buyer-lessor. However from an accounting consideration, as illustrated below, the seller-company may consider separate lease contracts.

IFRS 16 addresses interdependence of lease payments and sale price

This interdependence between the lease payments and sale price in a sale and leaseback transaction is addressed in IFRS 16. If the fair value of the sale consideration does not equal the fair value of the asset, or if the payments for the lease are not a market rates, any below-market terms are to be accounted for as a prepayment of lease payments and any above-market terms are to be accounted for as additional financing provided by the buyer-lessor to the seller-lessee. These adjustments would adjust the sale proceeds to their fair values.

First Fault – To only recognise a portion of the Gain from Sale Component of Sales and Leaseback

Company A disposes its office unit in a building for $10 million, releasing liquidity and generating a profit on disposal of $7 million. The $10 million proceeds represent the fair value of the building. The carrying amount/cost of the building is $3 million. The lease liability in the leaseback amounts to $4 million.

In IASB's view, this $4 million lease liability represents the rights to use the underlying asset that is retained by the seller-lessee. As these rights are not transferred to the buyer-lessor, the "gain" of $2.8 million ($4 million/$10 million * $7 million) relating to these rights are not to be recognised. Only the gain that relates to the rights transferred to the buyer-lessor of $4.2 million appropriately reflects the economics of the transaction and is recognised.

The accounting will be very different should Company A enter a separate lease contract, as illustrated below.

Company A		**Separate lease contract**	**Sale and Leaseback**
		$' million	$' million
1.	Sale proceeds (fair value)	10	10
2.	Carrying amount/cost of building	3	3
3.	Lease liability	5	4
4.	ROU asset	5	1.2 [4/10*3]
5.	Gain on sale of building	7	4.2 [6/10*7]

As illustrated above, the accounting outcome for leaseback transaction is very different from the accounting outcome should the sale component and the lease component be recognised separately. Hence in this illustration, Company A may be compelled to enter into a separate lease contract with another landlord because of the penalizing accounting consequence of sale and leaseback transactions.

Second Fault – Expanded Lease Measurement to include all Variable Lease Payments

At commencement date, a lessee measures lease liability at the present value of lease payments, which includes fixed payments and variable payments that depend on an index or a rate.

Variable lease payments that do not depend on an index or a rate

However, the measurement requirement for the lease component in a sale and leaseback transaction is expanded to also include variable lease payments that do not depend on an index or a rate.

Second Fault – A consequence of the First Fault

This expanded measurement requirement to include all variable lease payments is a consequence of the first requirement to only recognise a portion of the gain from the sale component of sale and leaseback transactions.

Why?

The crux of IFRS 16 requirement for sale and leaseback transaction is that only the gain relating to the rights transferred to the buyer-lessor can be recognised. This requirement necessitates the determination of the **proportion** of the asset retained by the seller-lessee. As seen in the illustration above, this **proportion** equals the proportion of lease liability over the fair value of the asset.

Here is where it gets interesting. If the payments for the lease are variable payments that do not depend on an index or a rate and are not in substance fixed payments, the lease liability measured based on paragraphs 26 – 28 of IFRS 16 would be nil. Should the **proportion** then be nil?

To address this, IASB issued an amendment to IFRS 16, effective for reporting periods beginning on or after 1 January 2024. In this amendment, Illustrative Example 25 is added to the Illustrative Examples accompanying IFRS 16.

Structuring or Legitimate Economics?

As mentioned above, IASB is of the view that from an economic standpoint, recognising only the amount of gain that relates to the rights transferred to the buyer-lessor appropriately reflects the economics of the transaction.

I could agree with this view prior to IFRS 16 when leaseback was accounted for as off balances sheet operating leases. This off-balance sheet accounting benefit was an incentive for companies to enter into sale and leaseback transactions.

However, if sale and leaseback transactions have economic substance, are legitimate business decisions and with the current requirement to recognise all leases on the balance sheet;

- *Is the existing accounting requirement punitive?*
- *Does it reflect economic substance?*
- *Does it prevent good economic decisions?*

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