Staff Paper

Project **Leases**

Topic **Sale and leaseback**

Introduction

1. At the joint meeting on Monday, the boards tentatively decided to delete two of the criteria for determining whether a contract is a purchase or sale of the underlying asset. The appendix to this paper sets out the changes to the staff draft/pre-ballot draft that this decision will require.
2. The staff think that the deleted criteria relate mainly to risks and rewards whilst the retained criteria, relate mainly to control. Consequently, we have redrafted the standard to refer to control only.
3. However, this has consequences for our approach to sale and leaseback transactions. Based on the boards' previous tentative decisions a transaction is accounted for as a sale and leaseback (rather than a financing) if it represents a sale or purchase of the underlying asset. A sale or purchase of the underlying asset (as previously defined) would occur when the seller/lessee at the end of the contract transfers control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset.
4. Deleting the reference to all but a trivial amount of the risks and benefits associated with the underlying asset from the definition of a sale/purchase will result in far more transactions being accounted for as sale and leasebacks rather than financings. This is because transactions would be accounted for as a sale

and leaseback unless the seller/lessee retains title (or is expected to retain title because of the existence of bargain purchase options) to the underlying asset. This represents a significant change to the boards' original decision which would have resulted in most transactions being accounted for as financings.

5. To be consistent with the boards' original tentative decision, the boards could do one of two things:

Approach A

(a) Retain the requirement to consider whether the transaction results in a purchase/sale of the underlying asset

(b) Define a purchase/sale (for the purposes of a sale and leaseback transaction only) as a transaction that transfers to another entity control of the underlying asset and all but a trivial amount of the risks and benefits associated with the underlying asset.

Approach B

(a) Delete the requirement to consider whether the transaction results in a purchase/sale of the underlying asset.

(b) Require an entity to account for a transaction as a sale and leaseback rather than a financing if the transaction transfers control of the underlying asset to the buyer/lessor and all but a trivial amount of the risks and benefits associated with the underlying asset.

6. The staff note that approach A results in two different definitions of what constitutes a sale/purchase within the same standard which is potentially confusing. However, approach B removes the concept that a sale and leaseback should only be accounted for as such if it results in a sale of the underlying asset to the buyer/lessor.

Question 1

Which approach (A or B) do the boards support?

Appendix – Proposed changes to the pre-ballot/staff draft of the Leases ED

A1. Paragraph 10 would be changed as follows:

An entity shall not apply this [IASB: [draft] IFRS / FASB: proposed Update] to contracts that meet the criteria for classification as a purchase or sale of an *underlying asset* (see paragraph 0). A contract is a purchase or sale of an underlying asset if, at the end of the contract, an entity transfers to another entity control of the underlying asset~~ or all but a trivial amount of the risks and benefits associated with the underlying asset~~. Such contracts do not meet the definition of a lease.

A2. Paragraph 118 would be changed as follows:

An entity considers all relevant facts and circumstances when determining whether control~~ or all but a trivial amount of the risks and benefits associated with~~ <u>of an </u>~~the~~ underlying asset is transferred. A contract normally transfers control of an underlying asset~~ or all but a trivial amount of the risks and benefits associated with the underlying asset~~ when the contract:

(a) automatically transfers title to the underlying asset to the transferee at the end of the contract term. During the contract term term, a transferee may have restricted rights over the underlying asset (eg ability to move the asset to another location or permit another entity to use the asset). However, once the entity transfers title, the transferee's rights are unrestricted.

(b) includes a bargain purchase option and it is reasonably certain that the transferee will exercise the option. A bargain purchase option is an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised. An entity that has a bargain purchase option is in an economically similar position to an entity that will automatically obtain title to the underlying asset. By exercising its bargain purchase option, the transferee can direct the use of, and receive the benefits from, the whole of the underlying asset for the whole of its life.

~~(c) specifies a fixed return for transferor. A transferor that has a fixed return and cannot obtain benefits from changes in the asset's value during or after the contract term may have surrendered to a transferee more than a trivial amount of the risks and benefits associated with the underlying asset.~~

(d) ~~covers the whole of the expected useful life of the asset and the transferor is expected to retain only trivial risks and benefits associated with the underlying asset at the end of the contract.~~