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Failed sale leaseback accounting example

March 15, 2019 / Steven Bragg Resale transaction occurs when the seller transfers assets to the buyer, and then rents out the assets from the buyer. These arrangements most often occur when the seller needs funds associated with the assets sold, although it still needs to occupy space. When such a transaction occurs, the first accounting step is to determine whether the transaction is at fair value. This can be judged from one of the following comparisons: Compare the difference between the selling price of an asset and its fair value. Compare the current value of the rental payment and the current market rental payment value. This can include estimates of any variable rental payments expected to be made. If this comparison results in the determination that the sale and lease back transactions are not at fair value, the entity must adjust the sale price on the same basis only used to determine whether the transaction is at fair value. This may result in the following adjustments:Any increase in the sale price of an asset is calculated as a prepayment of the leaseAll reductions in the sale price of the asset are taken into account as additional financing provided to the seller-lessee by the buyer-lessor. The seller-lessee shall adjust the interest rate on this liability to ensure that:Interest on liabilities is not greater than the principal payment over the short term of the lease term and financing term; and The amount of carriage of assets is not greater than the amount of liability on the date of termination of the initial lease or the date when the asset control switches to the buyer-lessor. In this arrangement, considerations paid for assets are taken into account as financing transactions by both parties. However, if there is a repurchases option where the seller can later repurchas the asset, then the initial transaction cannot be considered a sale. The only exceptions are when:There are alternative assets available in the market, and the Price at which the option can be exercised is the fair value of the asset on the option exercise date. If sell and lease back transactions are not considered sales, then the lessee-seller cannot debit the assets, and accounts for any amount received as liabilities. In addition, the buyer-lessor does not recognize the transferred assets, and accounts for any amount paid as receivables. Related CoursesJak Sewa 15 March 2019/ Steven Bragg/ In February 2016, FASB published the Accounting Standards Update (ASU) 2016-02, Rent (Topic 842). Topic 842 will replace the existing rental guide (Topic 840), which has been in effect since 1977. 2016-02 will be effective for public companies for the fiscal year (and the temporary period in those fiscal years) starting after December 15, 2018. For private companies, the standard will be fiscal year starting after December 15, 2019 (and the interim period starting the following year). This standard allows early adoption and requires the use of modified retrospective transition methods. This article will provide a brief overview of lower and lower accounting, followed by a more detailed discussion and analysis of the terms of sale and lease back in ASC Topic 842. While some transactions can easily be identified as sell and lease back (SLB) transactions, the classification of certain other arrangements can pose challenges for the company. Bonafide sale and lease back transactions must meet sales criteria based on Accounting Standards Codification (ASC) 606, Income from Contracts with Customers, and lease back criteria under ASC 842.Lessors classifies rental transactions as operating leases, lease type sales, or direct financing leases. This classification is determined based on whether the lease agreement substantially transfers all the risks and rewards of ownership of the underlying asset from the lessors to the lessee. In lease transactions of this type of sale, lessors decognize rental assets and recognize their net investment in leases. In short, the lessor will record the payment of receivable leases for their current value at the date of commencment of the lease payment, plus the current value of any remaining undirectional asset value at the end of the lease term (ASC 842-30-30-1). Lessors calculates and recognizes any profit or loss of sale at the commenm of the lease as the fair value of the underlying asset (or the amount of lease receivables and prepaid lease payments by the lessee, if lower), less the underlying amount of the underlying asset's remaining undirectional assets, less than the initial direct deferred cost of the lessor. Lessor can recognize advance gains if and only if lessees have gained control of rental items. In direct financing arrangements, the lessor, consistent with ASC 606 and unlike with lease type sales, does not recognize the selling profit at the time of commencement of the lease because the arrangement does not transfer control of the underlying asset to the lessees. When the lessor transfers ownership but not control of the asset to the lessee, it has effectively converted the risks arising from the ownership of the underlying asset into credit risk. In direct financing leases, lessors derecognize rental assets and record net investments in the same way as lease type sales (ASC 842-30-30-2); however, lessors do not recognize upfront selling profits, but delay and acknowledge those gains on a flat (using effective interest rate method) through the contract period. In operating leases— unlike the type of sales and direct financing leases — the lessor maintains the assets on their balance sheet and their depreciation during a useful life. Rental income is recognized at (or other systematic basis, as it should be). Ownership and control of rental goods remains with the lessor. Exhibit 1 summarizes three different lessor accounting methods in a typical lease agreement. The Summary of Three Methods of Lessor AccountingLessees recognizes usage rights assets (ROU) and rental obligations on their balance sheets for almost all rental obligations (except short-term leases, that is, those with a duration of 12 months or less). FASB has adopted a dual model of lessee accounting that allows lessees to classify leases as either operating or financial leases — a different approach from the single model adopted by the IASB. Financing leases based on the new Topic 842 are categorically no different from capital leases based on previous guidelines in Topic 840. Operating leases reflect rental costs in a straight line (similar to operating leases under previous guidance); however, lease financing results in rental costs being loaded up front (similar to the current capital lease under previous guidance). In SLB transactions, the lessee-seller sells one of its assets to the buyer-lessor in exchange for consideration and making periodic lease payments to the buyer-lessor in exchange for maintaining the use of the asset. Because ASC 842 requires lessees to recognize most leases (except 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 to seller-lessees, but remain attractive for other reasons. The benefits of SLB transactions are as follows:Generate cash flow for seller-lesseeRepresent alternative financing and more effectively for seller-lesseeTransfer ownership taxes and related benefits to buyer-lessorsStrengthen seller-lessee balance sheet by reflecting lower financing amounts. ASC 840 applies SLB transactions only to lessees and includes detailed and specific guidelines for SLB real estate transactions; however, ASC 842 applies SLB transactions to lessees and lessors and has no specific guidance for SLB real estate transactions. FASB requires transactions to meet certain criteria to qualify as SLB transactions, as described below. In SLB transactions, sales must comply with ASC Topic 606. Income from Contracts with Customers. Topic 842 aligns the accounting of lessee and lessor in some major ways with the provisions of the income recognition guide in Topic 606, and does not distinguish between real estate rentals and other asset leases. Seller-lessees may take into account asset transfer as a sale if the following two conditions exist (ASC 842-40-25-1):The contract exists, based on ASC 606-10-25-1 to 25-8 The Seller-lessee meets its performance obligations by control of assets to buyer-lessors (ASC 606-10-25-30). Asset sales by seller-lessees imply that buyer-lessors (or customers) have gained control of the assets. If a transaction fails as a sale, it also fails as an SLB transaction. In bona fide SLB transactions, the seller-lessee recognizes the full amount of profit from the SLB transaction (ASC 842-40-25-1). If the lease-back phase of an SLB transaction fails, the buyer-lessor classifies the transaction as a type of sale or direct financing lease, and the seller-lessee classifies it as a financing lease (ASC 842-40-25-2). If the lessee-seller controls the underlying asset —that is, it can direct its use and obtain most of its remaining benefits — before transferring it to a buyer-lessor, the transaction can be classified as an SLB transaction if other criteria are satisfied (ASC 842-40-55-1). However, if the seller-lessee does not gain control over the underlying asset, even if he obtains a legal degree, before transferring it to the buyer-lessor, the transaction fails as an SLB transaction (ASC 842-40-55-2). The buyer-lessor obtains control of the asset when the contract exists (ASC 606-10-25-1 to 25-8) and the lessee-seller has performed his obligations by transferring control of the asset to the buyer-lessor. The topic of ASC 606 identifies five indicators that the customer (in this case the buyer-lessor) has gained control of the assets:The customer has a legal titleCustomer has physical ownershipCustomer has significant risk and ownership rewardsCustomer has received assetSeller has the right of payment at this time. This guide presents the above as an indicator rather than a criterion, and not all indicators should be present to conclude that the buyer-lessor has control over the transferred assets. Clearly, these indicators have shifted valuations for transfer controls in SLB transactions to buyer-lessors. SLB transactions also fail if the seller-lessee obtains control over the rental goods or provides guarantees on their value in the lease-back phase of the transaction. If control of the underlying asset is transferred to the seller-lessee in the lease-return transaction phase, the SLB transaction fails: the seller-lessee classifies the transaction as a financial lease, and the buyer-lessor classifies it as a lease type sale. If control of the underlying asset is not effectively transferred to the 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 lease financing, and the buyer-lessor classifies it as direct financing lease. Buyer-lessor and seller-lessees classify lease back transactions that have not failed as operating leases. ASC 842-40-30-1 requires seller-lessees and buyer-lessors to record SLB transactions conditions outside the market with fair value. Reasonable. and the buyer-lessor adjusts the number of sales if not at fair value. If the seller-lessee sells the asset and receives a yield that is less than the fair value of the asset, he recognizes the difference as a prepaid lease. If the proceeds of the sale are higher than the fair value of the asset, it recognizes the excess as an additional loan (ASC 842-40-55-24). If the buyer-lessor buys the asset and makes a payment that is less than the fair value of the asset, he recognizes the difference as additional financing. If the result is higher than the fair value of the asset, it recognizes the excess as a prepayment of the lease (ASC 842-40-30-2). Seller-lessee may have certain rights or obligations to buy back goods sold to customers under the following circumstances:Seller-lessee may sign future agreements if it has an obligation to buy back goods sold. Seller-lessee can sign a call option agreement if it has the right to re-pursue the goods sold. When a lessee-seller transfers certain items with the terms of a forward option or substantive call, it limits the buyer-lessor's ability to control the goods he or she has received. As such, accounting for SLB transactions with substantial buyback 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 repurchases options in SLB transactions. The repurchases option does not preclude sales accounting if both of the following criteria are met:The seller-lessee may use the repur-chase option at the fair value of the current asset. Alternative assets are available in a market that is substantially the same as the underlying asset. If the option or repurchases obligation precludes the 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. The right of the buyer-lessor to require the seller-lessee to buy back the rental item is a laid option. The option placed creates an obligation (forward) for the seller-lessee to buy back the goods from the buyer-lessor. If the buyer-lessor's sale price (or seller-lessee resale price) is lower than the original sale price or applicable market value, the buyer-lessor most likely has no significant economic incentive to exercise the put option. In such transactions, sales have return rights within the scope of revenue recognition guidelines, but transactions do not always fail as SLB transactions. If the buyer-lessor's sale price (or seller-lessee repurchases price) is higher than the original sale price or applicable market value, then the buyer-lessor most likely has a significant economic incentive to exercise the option The transaction failed as a sale, and the lease was returned is a financing arrangement. The following reflects first-year journal entries from seller-lessee and buyer-lessor in hypothetical SLB transactions. That doesn't cover all of the scenarios discussed above. A lessee-seller sold an oil rig with a book value of $240 million to a buyer-lessor for the same price and immediately leased it back. The following additional information is available:Rental payments are $100 million per year in arrears. The lease term back is three years without renewal. The seller-lessee incremental borrowing rate is 7%. The buyer-lessor's sale price is $262 million. The rest of the oil rig life is three years. Exhibit 2 reflects the payment per year from a seller-lessee perspective; Exhibit 3 reflects them from a buyer-lessor perspective. Annual Rental Payments from a Seller-lessee Perspective ($in millions) Annual Rental Payments from a Buyer-Lessor Perspective ($in millions)Initial sales journal entry First year journal entry:Operating leasePresentation of rental payments Rental paymentsDepression of corresponding rental payments Rou Depreciation and corresponding deductions for ROU ($262 ÷ 3). Lease financingValue payment of leaseDepreciation of ROU and corresponding deduction to ROU ($262 ÷3). Annual rental payments and allocations to finance costs and lease responsibilities First year journal entry:Operating leaseLease payments receivedDepreciation of leases Rental type RentalsRecognition of profits for assets sold (leased) as part of transactions SLBReceipt lease paymentsDirect lease financingAll sold (leased) and suspended in nition reco $ 22 other incomeReceipt rental payments and recognition of interest and other incomeDetermining whether the sale has occurred and seller-lessee has transferred control to the buyer-lessor in the context of Topics ASC 606 and ASC Topics 842 complicated and influence the initial and subsequent accounting treatment of SLB transactions. In addition, several other factors determine the proper accounting for the lease back phase of SLB transactions, such as repurchasing terms such as call options, forwarding agreements, and placing options. Finally, ASC 842, like other principle-based guidelines, requires the implementation of significance assessment for its proper implementation and implementation. Accounting for SLB transactions is complicated, and this article explores only some of the basic concepts of these transactions. The CPA advises businesses involved in such transactions would do well to study the full guidelines and determine how it applies to their specific business activities. Activities.

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