FASB addresses sale and leasebacks, US GAAP topics in leases project

What you need to know

- The FASB decided that repurchase options exercisable at fair value would not preclude sale accounting for sale and leaseback transactions involving non-specialised underlying assets that are readily available in the marketplace.
- The FASB decided that lessees that are not public business entities could make an accounting policy election to use the risk-free rate for the initial and subsequent measurement of lease liabilities. This is consistent with the FASB's 2013 proposal.
- The FASB affirmed its 2013 proposal to eliminate today's accounting model for leveraged leases, but decided that leveraged leases that exist at transition would be grandfathered.
- The FASB also affirmed its 2013 proposal for lessees and lessors to account for related party leases on the basis of the legally enforceable terms and conditions of the lease.

Overview

At a separate Financial Accounting Standards Board (FASB) meeting in August 2014, the FASB continued to redeliberate its 2013 joint proposal¹ to put most leases on lessees' balance sheets.

At the FASB-only meeting, the FASB made more decisions to clarify the proposed guidance on the accounting for sale and leaseback transactions. It also affirmed its 2013 proposed decisions about the discount rate for lessee entities that are not public business entities (PBE), the accounting for leveraged leases and the accounting for related party leasing transactions. The FASB's latest decisions, like all decisions to date, are tentative.

¹ See the Exposure Draft: Leases on the IASB's website.
Key decisions

Sale and leaseback transactions

The FASB decided that it will include application guidance on determining whether a sale occurs in the context of a sale and leaseback transaction in a new leases standard. That decision follows a joint decision by the International Accounting Standards Board (IASB) and the FASB (collectively, Boards) in July that a seller-lessee would use the new revenue recognition standard developed jointly by the Boards to determine whether a sale has occurred in a sale and leaseback transaction. That is, a seller-lessee would assess whether the buyer-lessor has gained control of the underlying asset. Under the new revenue standard, control of an underlying asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

The FASB also clarified that for sale and leaseback transactions, repurchase options would not preclude sale accounting when all of the following conditions are met:

- The option is exercisable only at the then-prevailing fair market value (i.e., at the time of exercise) of the underlying asset
- The underlying asset is a non-specialised asset
- The underlying asset is readily available in the marketplace

The FASB believes that such a repurchase option is effectively non-substantive and therefore should not preclude sale accounting in a sale and leaseback transaction. The FASB staff indicated that it believes real estate would not meet the non-specialised asset condition above. The IASB previously concluded that a sale would not occur if the seller-lessee has a substantive repurchase option, but did not address whether options meeting the criteria above would be substantive.

How we see it

The FASB discussed an example of a leased automobile and appeared to agree that such an asset would generally be non-specialised and would be readily available in the marketplace. However, determining when a leased underlying asset is non-specialised and readily available in the marketplace will require judgement.

The FASB also affirmed its 2013 proposal that the seller-lessee and the buyer-lessor would account for a failed sale and leaseback transaction as a financing. This decision would align with the FASB’s decision in July 2014. The FASB asked its staff to develop examples of how, consistent with current practice, entities would adjust the financing obligation’s discount rate to eliminate:

- Negative amortisation of the financing obligation (i.e., circumstances when the outstanding balance of the financing obligation increases over the lease term)
- A built-in loss at the end of the lease (i.e., circumstances when the carrying value of the underlying asset exceeds the financing obligation at the end of the lease)

Discount rate policy election for entities that are not public business entities

Consistent with its 2013 proposal, the FASB decided that lessees that are not PBEs would be permitted to make an accounting policy election to use the risk-free rate for the initial and subsequent measurement of lease liabilities. The risk-free rate would be determined using a period comparable with the lease term. The accounting policy election would have to be applied to all leases and disclosed in the footnotes.

2 See IFRS 15 Revenue from Contracts with Customers.
3 See our IFRS Developments 88: Boards address sale and leaseback transactions, lessor disclosures (AU2546).
Although the use of a risk-free rate might reduce complexity for lessees, it would increase the likelihood that the present value of the lease payments would amount to substantially all of the fair value of the leased asset, potentially resulting in a Type A lease (similar to a capital lease today). This might dissuade some entities from using the ‘relief’.

Leveraged leases
Consistent with the 2013 proposal, the FASB decided to eliminate leveraged lease accounting under a new leases standard. However, it decided that leveraged lease arrangements that exist at transition would be grandfathered.

How we see it
Leveraged leases that exist at transition would be grandfathered.

With its decision to grandfather existing leveraged leases, the FASB is responding to constituents’ concerns that the transition provisions of the 2013 proposal would have been too costly and complex to apply to certain transactions.

Related party leasing transactions
Consistent with its 2013 proposal, the FASB decided that lessees and lessors would be required to account for related party leases on the basis of the legally enforceable terms and conditions of the lease. This decision would eliminate the current requirement under US GAAP for lessees and lessors to evaluate the economic substance of a lease to determine the appropriate accounting. Lessees and lessors would still be required to apply the disclosure requirements for related party transactions in accordance with US Accounting Standards Codification (ASC) 850 Related Party Disclosures.

What’s next
Before issuing a new leases standard, the Boards will redeliberate several remaining issues, including the IASB’s recognition and measurement exemption for leases of small assets, lessee disclosure and transition. It is not clear whether, when or to what extent the Boards will discuss the definition of a lease. The FASB will also separately discuss not-for-profit issues.
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