Accounting

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Global

Insights into PFRS 16

Sale and leaseback accounting

PFRS 16 makes significant changes to sale and leaseback accounting. A sale and leaseback transaction is one where an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) for consideration and leases that asset back from the buyer-lessor.

A sale and leaseback transaction is a popular way for entities to secure long-term financing from substantial property, plant and equipment assets such as land and buildings.

PAS 17 covered the accounting for a sale and leaseback transaction in considerable detail but only from the perspective of the seller-lessee.

As PFRS 16 has withdrawn the concepts of operating leases and finance leases from lessee accounting, the accounting requirements that the seller-lessee must apply to a sale and leaseback are more straight forward. In addition, PFRS 16 provides an overview of the accounting requirements for buyer-lessors too.

When a seller-lessee has undertaken a sale and lease back transaction with a buyer-lessor, both the seller-lessee and the buyer-lessor must first determine whether the transfer qualifies as a sale. This determination is based on the requirements for satisfying a performance obligation in PFRS 15 'Revenue from Contracts with Customers'.

The accounting treatment will vary depending on whether or not the transfer qualifies as a sale. This is described below.

Transfer of the asset is a sale

If the transfer qualifies as a sale and the transaction is on market terms the seller-lessee effectively splits the previous carrying amount of the underlying asset into:

- a right-of-use asset arising from the leaseback, and
- the rights in the underlying asset retained by the buyer-lessor at the end of the leaseback.

The seller-lessee recognizes a portion of the total gain or loss on the sale. The amount recognized is calculated by splitting the total gain or loss into:

- an unrecognized amount relating to the rights retained by the seller-lessee, and
- a recognized amount relating to the buyer-lessor's rights in the underlying asset at the end of the leaseback.

The leaseback itself is then accounted for under the lessee accounting model.

The buyer-lessor accounts for the purchase in accordance with the applicable standards (eg PAS 16 'Property, Plant and Equipment' if the asset is property, plant or equipment or PAS 40 'Investment Property' if the property is investment property). The lease is then accounted for as either a finance lease or an operating lease using PFRS 16's lessor accounting requirements.

Adjustments are required if consideration for the sale is not at fair value and/or payments for the lease are not at market rates. These adjustments result in recognition of:

- a prepayment to reflect below-market terms
- additional financing provided by the buyer-lessor to the seller-lessee to reflect above-market terms.

Example – Sale and leaseback

SellCo sells a building to BuyCo for cash of Php1,800,000, which is its fair value at that date. The previous carrying value of the building is Php1,000,000. At the same time, SellCo enters into a lease with BuyCo conveying back the right to use the building for 18 years. Annual payments are Php120,000 payable at the end of each year, which is at market rate. The transfer qualifies as a sale based on the guidance on satisfying a performance obligation in PFRS 15.

The rate implicit in the lease is 4.5%, which is readily determinable by SellCo.

Analysis

(a) SellCo

The present value of the annual payments (18 payments of Php120,000, discounted at 4.5%) is Php1,459,200.
SellCo measures the right-of-use asset retained through the leaseback as a proportion of the previous carrying amount of the building. This is calculated as: Php1,000,000 (previous carrying value) x [Php1,459,200 (PV of lease payments)/ Php1,800,000 (fair value of building)]. The right-of-use asset calculated in this way is Php810,667.
SellCo recognizes a portion of the total gain on the sale, to the extent it relates to the rights retained in the underlying asset by BuyCo at the end of the leaseback. The total gain on sale of building is Php800,000 (Php1,800,000 – Php1,000,000). This total is split into:

- the portion relating to the rights to use the building retained by SellCo, calculated as Php800,000 x [Php1,459,200/Php1,800,000] which is Php648,533; and
- the portion relating to BuyCo's rights in the underlying asset at the end of the leaseback, calculated as Php800,000 x [(Php1,800,000 – Php1,459,200)/Php1,800,000], which is Php151,467

At the commencement date, SellCo's accounting entries are:

	Debit (Php)	Credit (Php)
Cash	1,800,000	
Right-of-use asset	810,667	
Building		1,000,000
Gain on sale		151,467
Lease liability		1,459,200

(b) BuyCo

At the commencement date, BuyCo's accounting entries are:

	Debit (Php)	Credit (Php)
Building	1,800,000	
Cash		1,800,000

BuyCo classifies the lease as an operating lease taking into account, among other things, that the present value of the lease payments is 19% less than the fair value of the building. BuyCo accounts for the lease accordingly.

Transfer of the asset is not a sale

If the transfer does not qualify as a sale the parties account for it as a financing transaction. This means that:

- the seller-lessee continues to recognize the asset on its balance sheet as there is no sale. The seller-lessee accounts for proceeds from the sale and leaseback as a financial liability in accordance with PFRS 9. This arrangement is similar to a loan secured over the underlying asset – in other words a financing transaction.
- the buyer-lessor has not purchased the underlying asset and therefore does not recognize the transferred asset on its balance sheet. Instead, the buyer-lessor accounts for the amounts paid to the seller-lessee as a financial asset in accordance with PFRS 9. From the perspective of the buyer-lessor, this arrangement is a financing transaction.

Sale and leaseback transactions on transition to PFRS 16

Where the overall sale and leaseback arrangement has been settled (ie the lease has expired) before the date of initial application of PFRS 16 then there is nothing to consider.

However, those transactions that are important to consider on transition to PFRS 16 are those sale and leaseback transactions entered into before the date of initial application of PFRS 16 and which still have historic balances that need to be accounted for until the end of the leaseback period.

Therefore, on applying PFRS 16 for the first time, an entity will need to consider any on-going leases, and assets and liabilities that remain because of historic sale and leaseback transactions accounted for under PAS 17.

The following questions should be considered when determining the correct accounting treatment on transition to PFRS 16:

1. Do entities re-assess sale and leaseback transactions arising before transition to assess whether they were a sale under PFRS 15?

   The answer is no. The IASB have said that the historic judgements on previous sale and leaseback arrangements are not re-opened.

   PFRS 15 is only applicable when a sale and leaseback transaction has occurred on or after the date of initial application of PFRS 16.

2. From the perspective of the seller-lessee, what if a transaction was a sale and finance leaseback under PAS 17?

   Where a transaction was a sale and finance leaseback the entity continues to account for the finance leaseback like any other finance lease at transition to PFRS 16.

   For example, the seller-lessee will reflect a right-of-use asset and a lease liability.

   Any deferred gain arising on the historical application of PAS 17 continues to be amortized going forward under PFRS 16.

3. From the perspective of the seller-lessee – what if a transaction was a sale and operating leaseback under PAS 17?

   The entity accounts for the operating leaseback like any other operating lease at transition to PFRS 16. The seller-lessee will again reflect a right-of-use asset and a lease liability.

   However, this time the seller-lessee adjusts the right-of-use asset for any deferred gains or losses relating to off-market terms remaining on the balance sheet immediately prior to date of initial application of PFRS 16.

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