EISNERAMPER

New Accounting Standards Allow Sellers or Lessees in Sale-Leaseback Transactions to Recognize Gain in Certain Circumstances

August 04, 2016

By Ed Opall, CPA

A very interesting by-product of the new revenue recognition standard (ASU 2014-09, *Revenue from Contracts with Customers – Topic 606*) issued on May 28, 2014 and the new lease standard (ASU 2016-02, Leases – Topic 842) issued on February 25, 2016 will be a change in accounting for sale-leaseback transactions, which is a popular tool for financing real estate and equipment. The primary reason for sale/leaseback transactions is to generate cash flow from appreciated long-term assets and still retain the right of use. If the transaction is structured properly in accordance with the new standards, seller/lessees will be allowed to recognize the sale immediately rather than defer recognition of gain over the life of the lease. Accordingly, it is likely that we will be seeing more of these transactions once the standards are adopted. Companies with significant real estate holdings who would employ sales and leasebacks as a financing vehicle would be able to strengthen their balance sheets as a result of this new guidance.

The effective date for revenue recognition (for calendar year reporters) is 2018 for public companies and 2019 for private companies. The effective date for the leasing standard (for calendar year reporters) is 2019 for public companies and 2020 for private companies with early adoption permitted in 2017. The revenue recognition standard allows for early adoption in calendar year 2017 for public companies and 2018 for private companies. Both the revenue recognition standards and the leasing standards need to be adopted in order to recognize the gains from sale-leaseback transactions.

In order to recognize the sale transaction, the transaction must qualify as a sale under the revenue recognition standards. Under the new revenue standards, the 5 core principles are as follows:

- Identify the contract with the customer.

RELATED STORIES

EisnerAmper Privately Owned Real Estate
November 16, 2017

EisnerAmper Real Estate Fund Services
November 16, 2017

Lease Accounting Standard Issued
March 01, 2016

- Identify the separate performance obligations in the contract.
- Determine the transaction price.
- Allocate the transaction price to separate performance obligations.
- Recognize revenue when performance obligations are satisfied.

A bona-fide contract would possess all of the following criteria:

- The parties to the contract have approved and are committed to perform their respective obligations.
- The entity can identify each party's rights regarding the goods or services to be transferred.
- The entity can identify the payment terms for the goods or services to be transferred.
- The contract has commercial substance (risk, timing, or amount of future cash flows are expected to change as a result).
- It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. An entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due.

The FASB to Re-Expose a Revised Exposure Draft on Lease Accounting

October 09, 2012

Clean Energy Forum: Financing and Regulatory Compliance

March 26, 2010

The key provision of the revenue recognition standard for sales treatment is that there must be commercial substance. The sale must result in a complete change of control from the seller to the buyer and there must not be substantive repurchase options tied to the agreement. The buyer must have paid the transaction price or have the ability and intention of paying the transaction price.

The transfer of control to the buyer/lessor must also be clear in the lease agreement to not include provisions that revert control back to the seller/lessee. Under the new leasing standards for lessees, leases are classified as either financing or operating. Only an operating leaseback would qualify the sale for immediate profit recognition in a sale/leaseback transaction. Below are the criteria for determining if a lease is a financing lease. If the lease does not have any of the stated criteria, it is considered an operating lease.

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease.
- The lease grants the lessee an option to purchase the underlying asset and the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset.
- The present value of the sum of the lease payments and residual value guaranteed by the lessee equals or exceeds the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use at the end of the lease term without significant modifications.

In essence, the lease must not be for such a long length of time and of such significant payment terms that it is in substance a sale of the property back to the lessee. The first 4 criteria are similar to the current standards, albeit without the bright-line objective tests. A new criterion has been added in the new standards where the underlying asset must have alternative uses with only reasonable alterations required to release to another lessee. That would preclude certain industrial equipment or certain improved real estate from sale recognition.

The standard also states that the buyer/lessor would need to classify the lease as an operating lease for their purposes as well for the sale/leaseback to be recognized. A lessor treats the lease as an operating lease unless both of the following criteria are met:

- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments and any third-party guarantees by third parties equals or exceeds the fair

value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy the residual value guarantee.

Under the new standards, both the sale transaction and the lease transaction will need to be recorded at fair value. Since both transactions are typically consummated as a package, the parties could (at least in theory) negotiate off-market terms on the sale and make up for it with off-market terms on the lease. The guidance requires adjustment of these terms to fair value so that the accounting reflects the commercial substance of the transaction; otherwise the seller/lessee ends up with deferred income or prepaid rent and not the intended result.

Once fully adopted, the new revenue and leasing standards could, if structured correctly, provide opportunistic seller/lessees to “more or less” have their cake and eat it too. Care needs to be taken to ensure that the “more or less” part of the strategy works. Consult your friendly accounting firm for guidance.

A sale-leaseback transaction that does not qualify for sales recognition would be considered a financing arrangement. The seller would retain the asset on its books, even though it no longer legally owns the asset. The cash proceeds would be considered a financing obligation.