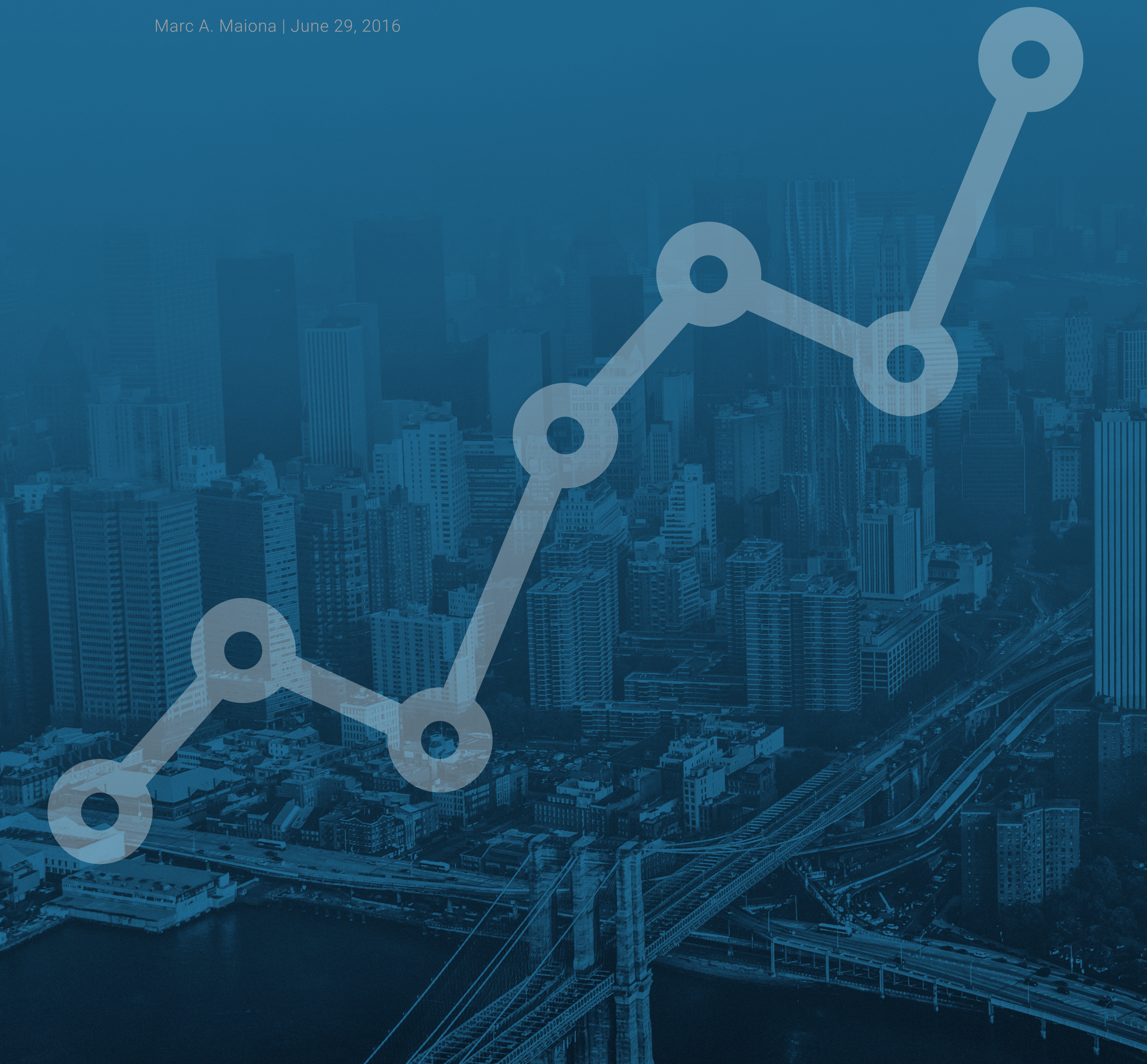
LeaseCalcs:
Sale-Leasebacks: the fuse is lit!

Marc A. Maiona | June 29, 2016



Sale-Leasebacks: The FASB & IASB just lit the fuse on SLBs!

It's not just about the "leaseback" coming onto the balance sheet – the treatment of the gain on sale will reduce the appeal of SLBs going forward.

Any company currently owning real estate that is used in its business operations, such as a corporate headquarters, manufacturing facility, distribution center or the like, that has either been highly depreciated or has seen significant appreciation, is well advised to pay close attention to the impact of the FASB's and IASB's changes to sale-leaseback accounting. If a company were ever to contemplate executing a sale-leaseback ("SLB"), it will be much more advantageous, from a financial reporting perspective, to have completed the transaction before the new rules become effective.

What many observers have overlooked is the fact the new lease accounting standards did not just create a sea change in the way leases are accounted for, they also created an even bigger change to the way the gains (or losses) on any SLB are accounted for under the new standards. To help explain the impact of this new world of SLB accounting a quick review of the way current standards work may prove helpful.

Overview of current SLB accounting.
Under current lease accounting standards, a company entering into a SLB transaction will essentially account for the transaction as one event with two related parts; the sale and the leaseback. In terms of the big picture of what happens on the financial statement, there are cash, balance sheet and P&L impacts, as follows:

- The sale of the property removes the net book value of the building, along with the land value, from the balance sheet and replaces it with cash in the amount of the net sales proceeds. The building and land values were classified as "fixed assets" while the cash received is a "current asset". Since in most cases the cash proceeds exceeds the net book value of the property sold, this is beneficial to the balance sheet both in terms of total assets and liquidity.
- Under current lease accounting standards nearly all SLBs have been structured in such a way to result in the "leaseback" portion of the deal to be classified as an operating lease (whether under ASC840 or IAS17), in order to

have the leaseback treated as an off-balance sheet transaction.

- Immediately following the closing of the transaction, the former owner and now tenant would report straight line rent expense on the P&L, but in an annual amount arguably higher – and potentially much higher – than the depreciation expense that would have been reported had it continued to own the property.
- The gain (or potentially the loss), the company would realize on the sale of the property would – from a GAAP or IFRS reporting perspective – then be deferred on a straight line basis over the leaseback period.[1] This is one of the hallmarks of SLB transactions under current standards, and is a critically important feature as the deferral of the gain that runs through the P&L over the leaseback period serves to offset the notable increase in P&L expense resulting from the replacement of old depreciation expense with new straight line rent expense.

Aside from the ability to monetize the value of an asset to reinvest in the business, one of the greatest advantages of SLBs from a financial reporting perspective is the deferral of the gain that results from the sale. This is due to the fact the deferral means the company does not have to explain a large one-time gain on its P&L and, perhaps more importantly, can use the deferral of the gain to "soak up" much, if not all, of the increase in expenses running through the P&L as a result of trading relatively low depreciation expense for higher straight line rent expense.

The New Rules Change The Sale Treatment, Not Just the Leaseback

In short, about the only thing the new accounting standards did not manage to change with SLB transactions was the removal of the fixed asset from the balance sheet in exchange for the cash proceeds. Virtually everything else has changed, and for many companies those changes are not for the better.

Most people who have followed the FASB's and IASB's work on the new standards have rightly focused on the "lease" in "lease accounting". As such, it is fairly widely known under the new rules all leases will be capitalized onto the lessee's balance sheet, with a corresponding "Right of Use Asset" and "Lease Liability". Without getting into the details of how those values are calculated (that's a subject for another article), suffice it to say the leaseback in every SLB is now on a roundtrip – it is coming right back onto the balance sheet, with impacts to shareholder equity, return on assets and, in certain cases (all cases for IFRS reporting companies), debt levels and related ratios.[2]

More critically, however, because of the way in which the new lease accounting standards interact with another set of new accounting rules known as "Revenue Recognition"[3] , SLBs under the new accounting regimes will be treated as two separate transactions: one being the sale and the other being the leaseback. It is this separation of the transaction into two distinct parts that dramatically alters the P&L treatment going forward.

No More Deferred Gains On SLBs After New Rules Take Effect

Because the new accounting rules treat the "sale" separately from the "leaseback", going forward there will be no deferral of any gain (or loss) recognized on the sale of a building into a SLB transaction. Rather, all of the gain will be recognized immediately. The impact of this change means for SLBs transacted after the new rules take effect the entirety of the gain will be recognized in the P&L the day the sale closes and the expense running through the P&L will be significantly greater than what the depreciation expense would have been had the company continued to own the building. **For many companies this one-time "spike" in earnings and the permanent increase in the expense profile on the P&L during the leaseback period will very likely cause the SLB to be untenable from a P&L perspective.**

The excerpt of LeaseCalcs' report below illustrates one such example, where the seller / lessee completes a SLB after the new standards take effect and where the leaseback is classified as a "Type B" / operating lease under the new accounting standards. The result of which is the entirety of the gain is booked on the day the sale closes and the annual expense profile is materially greater than it would have been if the company had continued to own the building.

Fiscal Year End October	2019	2020	2021	2022
Profit & Loss Reporting				
FAS13 / IAS17 / SLE Rent Expense	8,185,189	8,185,189	8,185,189	8,185,1
Selling, General & Admin	1,848,000	1,903,440	1,960,543	2,019,3
Gain/Loss on Sale/Leaseback	(68,467,274)	-	-	
Total	(58,434,085)	10,088,629	10,145,732	10,204,5

Deferred Gains On Existing Operating Leases Cease, Too!

One of the most overlooked aspects of these accounting standards is not that there is no grandfathering for existing leases having to be brought onto the balance sheet. That has been well publicized. Rather, it is that for any pre-existing SLB where the leaseback was classified as an operating lease, any as-yet-unrecognized deferred gains will never provide any benefit to the company's P&L once the new standards become effective. Instead, the amount of the unrecognized gain being carried on the firm's balance sheet will bypass the P&L entirely on the effective date of the new rules and drop to retained earnings. In other words, any company that has already completed a SLB – or any company currently contemplating a SLB – had better understand the impact of that transaction on the P&L once the new standards take effect. Many companies are in for an unpleasant surprise.

The example below illustrates a company that completed its SLB before the change in accounting standards would have received the benefit of the deferred gain treatment for a few years, but then all of the remaining unrecognized gain dropped to retained earnings on the date the new accounting standards take effect.

Notably, there is a material increase in the P&L expense profile once the deferral ceases.

Fiscal Year End October	2016	2017	2018	2019	2020	2021
						Profit & Loss Reporting
FAS13 / IAS17 / SLE Rent Expense	8,183,522	8,183,522	8,183,522	8,185,189	8,185,189	8,185,18
Selling, General & Admin	1,848,000	1,903,440	1,960,543	2,019,359	2,079,940	2,142,33
Initial Direct Cost Amortization	1,667	1,667	1,667	-	-	
Gain/Loss on Sale/Leaseback	(4,564,485)	(4,564,485)	(4,564,485)	-	-	
Total	5,468,704	5,524,144	5,581,247	10,204,548	10,265,129	10,327,52

Adjustment to Retained Earnings / Equity on first Fiscal Year after Effective Date, 11/01/2018: ($54,773,819)

The One Silver Lining

While the new accounting standards mean companies – and their advisors – will need to look at SLBs in an entirely different light in order to maximize the financial statement benefits of these transactions, there is one silver lining – or opportunity – in the new standards. Nearly all SLBs have historically been structured to qualify for operating lease treatment, largely because companies did not want the leaseback showing up on the balance sheet. However, they do not need to be structured that way, particularly considering the leaseback will be making a roundtrip back onto the balance sheet under the new standards. But why would a company want to structure a leaseback as a capital lease under existing standards? Because that is where the one silver lining exists, and, besides, all leases are being capitalized onto the balance sheet anyway.

In the course of finalizing the new lease accounting standards the FASB and IASB decided any as-yet-unrecognized gains related only to SLBs where the leaseback was a capital lease under current standards, would continue to be deferred after the effective date of the new rules. In other words, for a company entering into a SLB today and structuring the leaseback as a capital lease, the deferral of the gain is grandfathered! The illustration below represents this scenario.

Fiscal Year End October	2016	2017	2018	2019	2020	2021
						Profit & Loss Reporting
Selling, General & Admin	1,848,000	1,903,440	1,960,543	2,019,359	2,079,940	2,142,33
Initial Direct Cost Amortization	1,667	1,667	1,667	1,667	1,667	1,66
Right of Use Amortization	5,239,855	5,239,855	5,239,855	5,239,855	5,239,855	5,239,85
Interest	4,629,260	4,501,155	4,352,739	4,182,389	3,988,367	3,768,81
Gain/Loss on Sale/Leaseback	(4,564,485)	(4,564,485)	(4,564,485)	(4,564,485)	(4,564,485)	(4,564,48
Total	7,154,297	7,081,632	6,990,320	6,878,785	6,745,344	6,588,19

The Opportunity: For companies looking to monetize highly depreciated or highly appreciated assets by way of a SLB, a viable option still exists that serves to protect the P&L.

But only for a short time, as the FASB and IASB have effectively lit a fuse on SLB transactions[4]. Some final things to consider before you rush complete a transaction:

- To achieve capital lease classification under current lease accounting the leaseback will have to be evaluated under existing capital vs. operating lease rules.
- Generally speaking, to achieve capital lease treatment usually requires a longer term lease – say upwards of or longer than 20 years. This in turn, however, should increase the sales proceeds and the resulting gain.
- Structuring a leaseback with “above market” or “below market” lease terms has accounting consequences, so be mindful of this in relation to the gain you expect to be able to defer.
- A company that only does a leaseback for a portion of the building will have to recognize some of the gain – i.e., not defer that portion – immediately, and leasing back too small of a portion of the building can result in all of the gain being recognized immediately.

Also, should a company wait to complete a SLB until after the new accounting standards take effect there are two other important considerations under the new rules:

- A SLB involving real estate cannot provide the seller / lessee with an option to reacquire the building, even at fair market value. Doing so will result in the transaction being accounted for as a financing of the building rather than a sale and leaseback.
- Under US-GAAPs new rules, the leaseback on a SLB entered into after the new standards take effect cannot be classified as a “Type A” / Finance lease, otherwise it, too, will be accounted for as a financing of the building rather than a sale and leaseback.

Finally, if you are not already subscribed to LeaseCalcs and need more information on how a SLB transaction might affect your – or your client’s – financials, please reach out to schedule a demo or to speak with one of our experts. **949.284.6900 or info@LeaseCalcs.com**

[1] There are certain exceptions to this deferral treatment, most notably where the tenant does not leaseback 100% of the property or when the gain exceeds the present value of the rent payments over the leaseback period.

[2] Any lease classified as a "Type A" (more recently referred to as a "Finance Lease") under the new standards – which will include all leases under the new IFRS standards – will have its associated liability technically classified as debt on the lessee's balance sheet.

[3] Refer to Accounting Standards Update No. 2014-09 from FASB and IFRS 15 from the IASB.

[4] This is not to say the entire SLB market will go away after the new standards take effect. Some companies will still find the asset monetization aspects of SLBs outweigh the GAAP / IFRS reporting aspects, though we expect those to be fewer in number.

info@LeaseCalcs.com | 949.284.6900 | 38 Discovery #100, Irvine, CA 92618