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SALE&LEASE BACK or COLLATERALIZED BORROWING?

Another accounting principle which is widely misunderstood and erroneously accounted in the financial statements is related to sale and lease back transactions.

As professional IFRS advisors, we have witnessed many corporate clients that recognized directly income the difference between carrying amount of fixed asset and consideration received from customer (in most cases, a leasing company or a bank) based on erroneous interpretation of the related standards (i.e. IFRS 16, IFRS 15 and IFRS 9). Considering the correct accounting application of most of the sale&leaseback transactions, the resulting misstatement of balance sheet and p&l can reach devastating levels!

Without diving into technical details, let us explain the basic principles to differentiate sale&leaseback and collaterialized borrowing transactions.

First of all, we should emphasize (and perhaps warn) that, in our country, most of the sale&leaseback agreements are indeed collateralized borrowing contracts and therefore accounting entries made under sale&leaseback agreements are inaccurate.

As a basic definition, in a sale and leaseback transaction, one entity (the seller-lessee) transfers an asset to another party (the buyer-lessor) and leases back that same asset.

Within the context of a sale and leaseback transaction, the transfer of an asset is accounted for as a sale only if the transfer meets the requirements in IFRS 15 for the transfer of an asset.

IFRS 15 states that if an entity has a right to repurchase an asset (a call option), the customer (i.e. leasing company) does not obtain control of the asset, because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from the asset. Consequently, if the entity has a substantive repurchase option with respect to the underlying asset, then no sale has occurred.

So, if the transfer of the asset does not meet the requirements for a transfer in IFRS 15, then no sale is recognised by the entity. Instead, the entity accounts for any amounts received relating to the leaseback as a financial liability applying IFRS 9. This is because such a transaction represents, in substance, a collateralized financing arrangement.

Accordingly, we must infer that, if an entity sells and leases-back its fixed asset and hold an option to buyback the related asset at the end of the leasing period, then this is not a sale and any amount received from leasing company must be recognized as financial liability! Naturally, the related fixed asset should continue to remain on the balance sheet.

As further confirmation, we should emphasize the principles stated under IFRS15. For example, in IFRS15 paragraph B66 it is explicitly mentioned that if an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer (i.e. in most of the cases a leasing company) does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. If the contract is part of a sale and leaseback transaction, the entity shall continue to recognise the asset and shall recognise a financial liability for any consideration received from the customer. The entity shall account for the financial liability in accordance with IFRS 9.

Consequently, as we have underlined at the beginning of our article, most of the accounting entries made by our companies based on sale&leaseback transcations are erroneous and the magnitude of financial misstatement can sometimes reach very high levels that will eventually mislead financial statement readers and investors.