Lessor accounting: how the new lease and revenue standards interact

What you need to know

- Recent changes to the lessor accounting model to align it with the FASB's new revenue recognition guidance will have implications in two areas: transactions with variable payments and sales and leasebacks.
- Under the new standards, contracts with variable payments may be accounted for differently, depending on the type of variable payment and whether the transaction is subject to the revenue or leasing guidance.
- Lessors will need to apply the new sale and leaseback guidance, including evaluating the "sale" under the FASB's new revenue guidance.
- A failed sale and leaseback transaction will be accounted for as a loan.

Key changes to lessor accounting guidance

	Current GAAP	*New guidance*
Variable payments (consideration)	The leasing and revenue recognition guidance are generally aligned with respect to usage-based payments. Under either standard, lessors recognize variable payments as revenue in the period earned.	Leases guidance: Variable payments based on usage are not included in the lease receivable or lease income until earned. Revenue guidance: Variable payments may be recognized as revenue upfront, provided certain conditions are met.
Sale and leaseback transactions	Specific sale-leaseback guidance applies to seller-lessees of real estate. For sale-leasebacks of equipment, seller-lessees follow revenue recognition guidance applicable to sales of equipment and leasing guidance for the leaseback and recognition of any profit or loss on sale. Buyer-lessors follow guidance for purchases of property, plant, and equipment for all assets purchased and leasing guidance for the leaseback of the purchased asset to the seller-lessee.	Specific sale and leaseback guidance applies to both lessees and lessors, with the same model applied to transactions related to all assets. The transfer of the asset to the buyer must qualify as a sale under the new revenue recognition guidance.

The changes to lease accounting and their outcomes

The FASB recently issued its new guidance on lease accounting. While the changes are primarily targeted at lessee accounting, the lessor model was updated to align with certain changes made to the lessee model and the FASB's new revenue recognition standard. This alignment will result in the following implications.

- Whether a transaction with variable payments is subject to the revenue or leasing guidance may determine when revenue is recognized by the supplier.
- More transactions may fail to qualify for sale and leaseback accounting. A failed sale and leaseback transaction is considered a financing, and the buyer-lessor records a loan receivable, rather than the physical asset.

Leasing is fundamentally a revenue-generating activity for lessors…
ASU 2016-02, *Lease Accounting*, Summary

Contracts with variable payments

Consider a supply contract in which a manufacturer supplies equipment to a customer. Control of the equipment transfers at contract inception and the transaction qualifies as a sale under the new revenue guidance. During the following 12 months, at each month-end, the customer is required to pay the supplier (1) a fixed amount plus (2) a variable amount based on a percentage of sales from the use of the equipment during the month. The new revenue recognition model requires companies to estimate variable consideration and recognize revenue when control transfers. In this case, that is at inception.

In contrast, suppose a transaction with similar payment terms is subject to the lease guidance and classified as a sales-type lease. As such, the manufacturer (the lessor) would exclude the variable payments from contract consideration. Lease income would not be recognized for the variable payments at lease commencement; rather, it would be recognized when and if earned.

As the example demonstrates, whether the revenue or lease guidance governs the transaction impacts the timing of the lessor's revenue recognition.

What lessors should consider

Lessors and lessees in sales-type leases may have different preferences as to whether rent payments are fixed or variable. Lessors may prefer fixed payments, which are recognized as revenue at lease commencement. However, lessees may prefer variable payments based on usage, which are likely to reduce the lease liabilities on their balance sheets. Both parties need to consider which payment structure achieves their objectives.

Sale and leaseback transactions

In a sale and leaseback transaction, a seller-lessee sells an asset to a buyer-lessor and simultaneously leases it back.

The new leases standard introduces criteria for sale and leaseback accounting that apply to both lessees and lessors. This is a significant change for buyer-lessors. Previously, only lessees of real estate were subject to stringent conditions to qualify for sale and leaseback accounting. A buyer-lessor's purchase of an asset from and subsequent lease to a seller-lessee were accounted for as a separate purchase and lease.

To achieve sale and leaseback accounting under the new leases guidance, the transfer of the asset from the seller-lessee to the buyer-lessor must qualify as a sale under the new revenue recognition guidance. To do so, the buyer-lessor needs to obtain control of the asset, considering the indicators in the revenue recognition standard.

The existence of a leaseback that the seller-lessee classifies as a finance lease or the buyer-lessor classifies as a sales-type lease precludes the asset transfer being considered a sale as the seller-lessee effectively retains control of the underlying asset.

Also, certain types of repurchase options may preclude the transfer of an asset from being considered a sale. Those that are exercisable (1) at other than the asset's fair value at the time of exercise or (2) for assets without available, substantially similar alternatives would prevent the transfer of the asset from qualifying as a sale.

Repurchase options in equipment leases are typically at a fixed price, which is sometimes preferred as it avoids the uncertainty of a price based on fair value. A fixed-price repurchase option would prevent the transaction from qualifying as a sale.

Repurchase options related to real estate may also be problematic. Real estate is considered unique in that no two parcels have the same location. Due to the absence of a similar, alternative asset, the presence of a repurchase option in a sale and leaseback of real estate would prevent the transfer of the asset from qualifying as a sale.

In each of the above examples, because the transfer of the asset does not qualify as a sale, sale and leaseback accounting would be precluded.

What lessors should consider

In some cases, the provisions that prevent sale treatment may be subject to negotiation. For example, changes to contract terms can impact the control conclusion and repurchase options can be modified or removed. Given that the new guidance applies to both buyer-lessors and seller-lessees, both parties have the same objective and may be more open to negotiations to achieve a common goal.

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How PwC can help

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