

842 LEASE ACCOUNTING

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Mike Cheng joined Frazier & Deeter in 2019 as the Partner who oversees the firm's professional practices related to accounting and audit. As part of this role, he specializes in assisting clients with complex accounting and financial reporting issues.

Prior to joining the firm, Mike was a Senior Project Manager at the Financial Accounting Standards Board (FASB). At the FASB, he served as the Private Company Council (PCC) coordinator, where he was responsible for all PCC related matters. In addition, Mike led projects to simplify the accounting for non-employee share-based payments, help shape the future of the FASB technical agenda and improve consolidations guidance (VIE guidance). Most recently, he worked on the FASB's implementation team on revenue recognition (ASC Topic 606) and lease accounting (ASC Topic 842).

Prior to joining the FASB, Mike held various management positions with PricewaterhouseCoopers. He was an Audit Senior Manager, Private Company Services, in the firm's Stamford, CT office. From 2003-2011, he also held roles of increasing responsibility in PwC's Core Assurance divisions in Buffalo and Rochester, NY.



Agenda

Leases

Allocation between leasing and nonleasing

Lease modifications

Sale and Leaseback

Allocation between Leasing and Nonleasing Components

Using land?

Fact Pattern:

- Company signs a contract to let the customer to use land for 10 years
- Payment equals \$1MM per year
- Owner grants access to the land on 12/31/2020 to the customer
- Cancellation of a contract incurs a significant penalty from either party

Questions:

- Is this a lease?
- On 12/31/2020 does the Company have a liability to the Landlord?

Landscaping Service

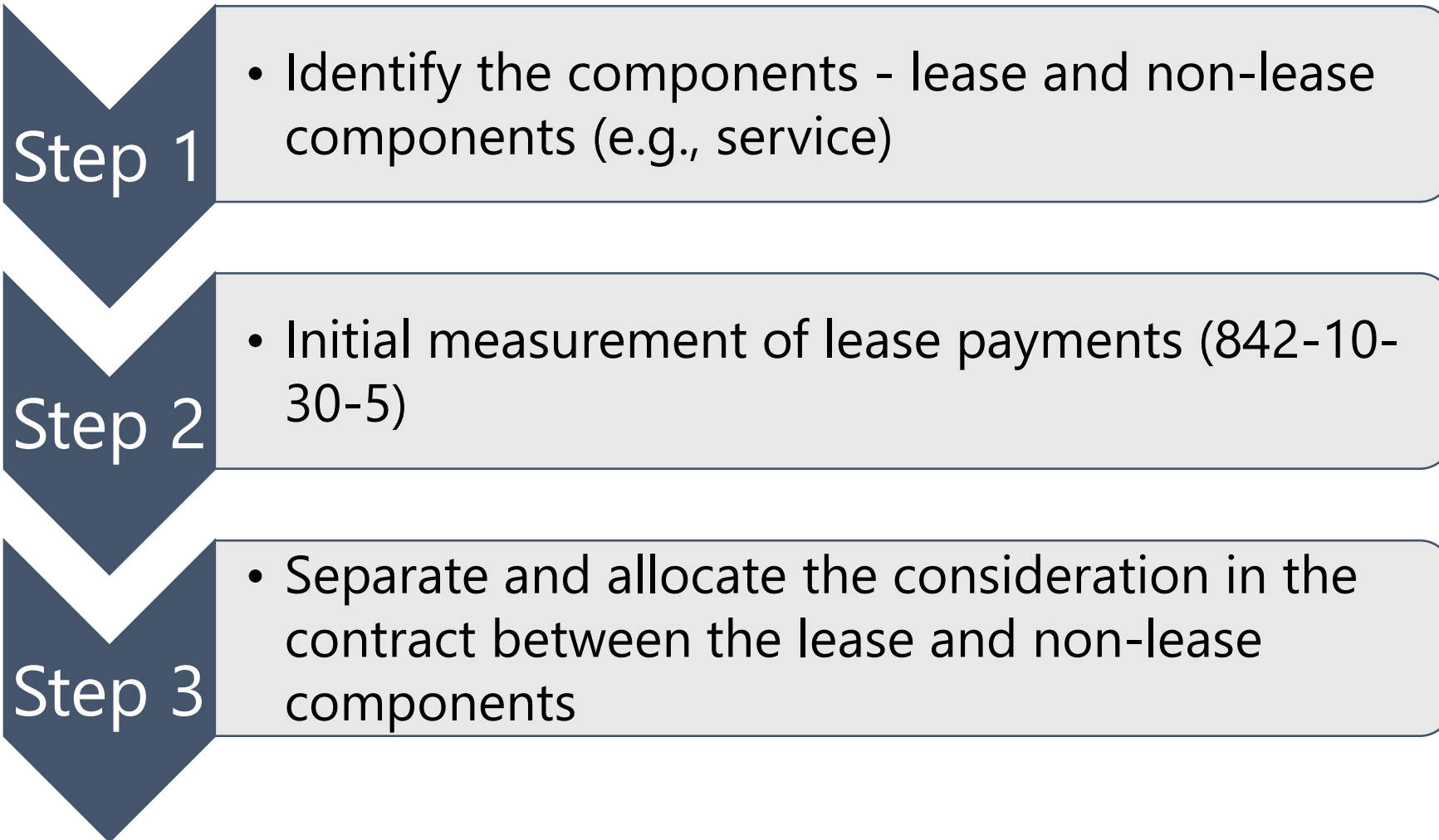
Fact Pattern:

- Signed a 3-year commitment for landscaping service because of favorable pricing on 12/31/2020
- Termination before 3 years will result in a significant penalty

Questions:

- On 12/31/2020 does the Company have a liability to the Landscaper?

ID Units and Allocating Consideration



Separate Lease Components

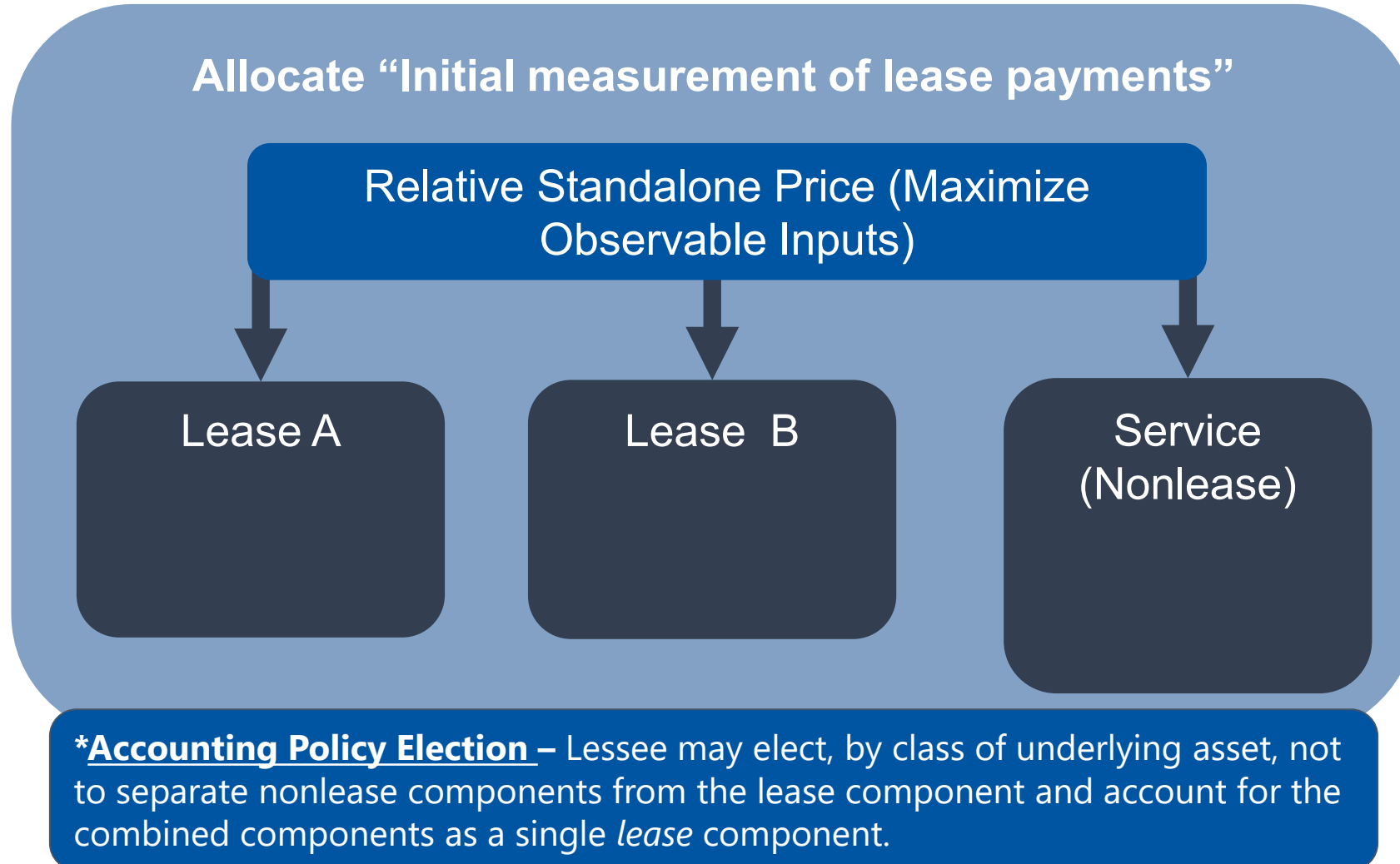
A right to use an underlying asset is a separate lease component if both:

- Lessee can benefit from use of the asset on its own or together with other readily available resources
- The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

Rights to use two or more underlying assets may be a single lease component

Similar to the distinct guidance in Topic 606 (the new revenue recognition standard).

Lease Allocation



Lessee – Operating Lease w/ CAM (No Election to Combine)

- 5 year retail store lease entered at end of 2020
- The contract states that the lease payment will be \$1000 the first year and increase 100 each year thereafter for a total of \$6000.
- Lessee also pays common area maintenance (CAM) charges to approximate \$300 each year. Lessor will bill the Lessee based on actual costs once a year.
- Discount rate is 6%
- Assume this is an operating lease
- Standalone price:
 - For the lease are the fixed payments in the lease contract (\$6,000 in total)
 - For CAM is expected to approximate \$300 each year (\$1,500 in total).

Is this what you would do?

- Fixed - Rent payment equals \$1,000 the first year and increases \$100 each year thereafter. Total payments over 5 years is \$6,000
- CAM – Variable Payments based on actual (expected to be approximate \$300 per year or 1,500 in total)
- Discount rate is 6%

Year	Rent Expense (a)	Lease Liability				Right of Use Asset		
		Beg	Int. (6%) (b)	Payment	End	Beg	Amort. =(a)-(b)	Ending
2020	-	-	-	-	(5,006)	-	-	5,006
2021	1,200	(5,006)	(300)	1,000	(4,306)	5,006	(900)	4,106
2022	1,200	(4,306)	(258)	1,100	(3,465)	4,106	(942)	3,165
2023	1,200	(3,465)	(208)	1,200	(2,472)	3,165	(992)	2,172
2024	1,200	(2,472)	(148)	1,300	(1,321)	2,172	(1,052)	1,121
2025	1,200	(1,321)	(79)	1,400	(0)	1,121	(1,121)	-
	6,000							

- Book entire payment based on actual CAM charges entirely as CAM Expense

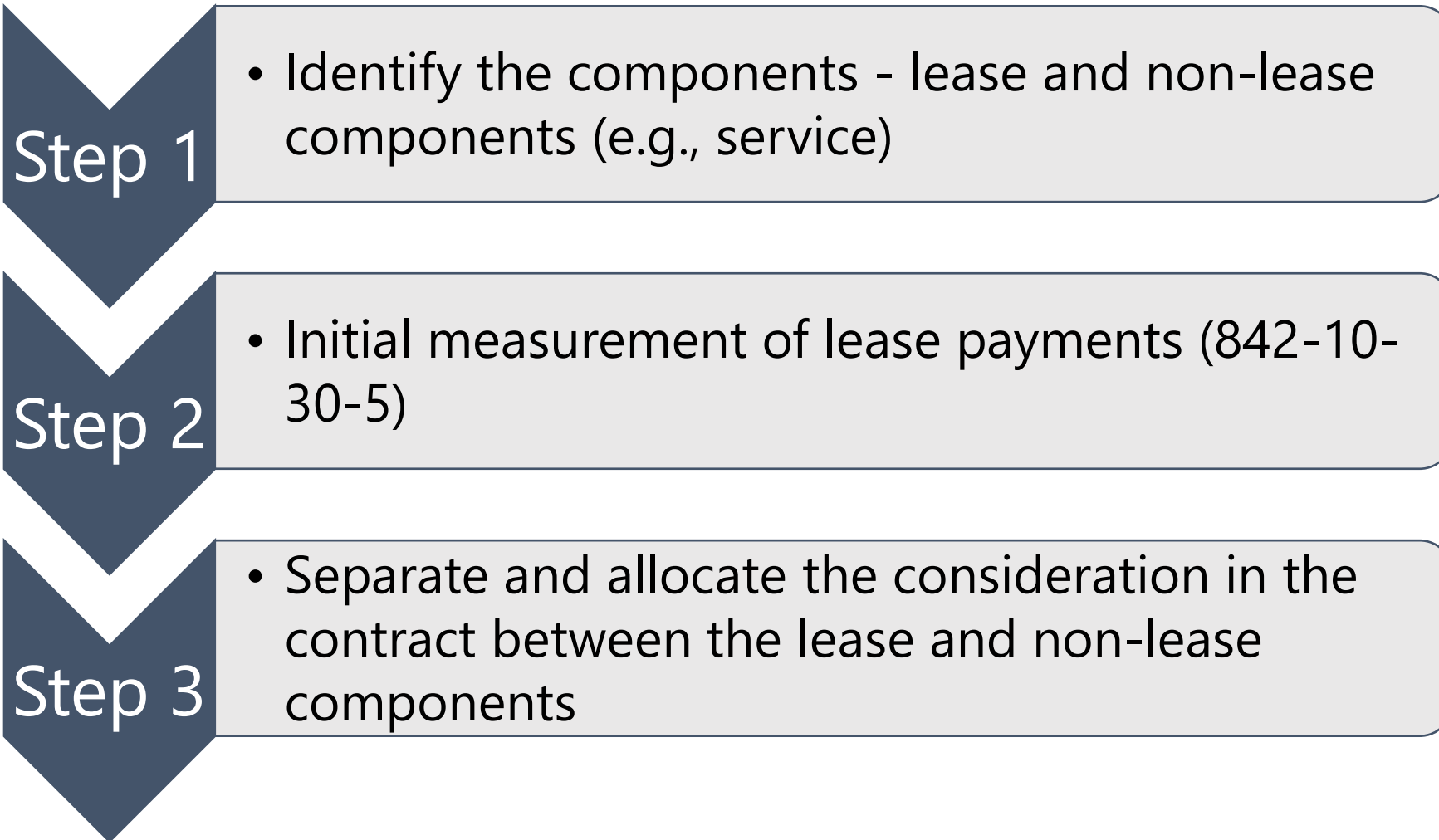
Is this what you would do?

- Fixed - Rent payment equals to ... increases \$100 each year thereafter. Total payments ...
- CAM - Variable Payment ... rate \$300 per year or 1,500 in total ...
- Discount rate ...

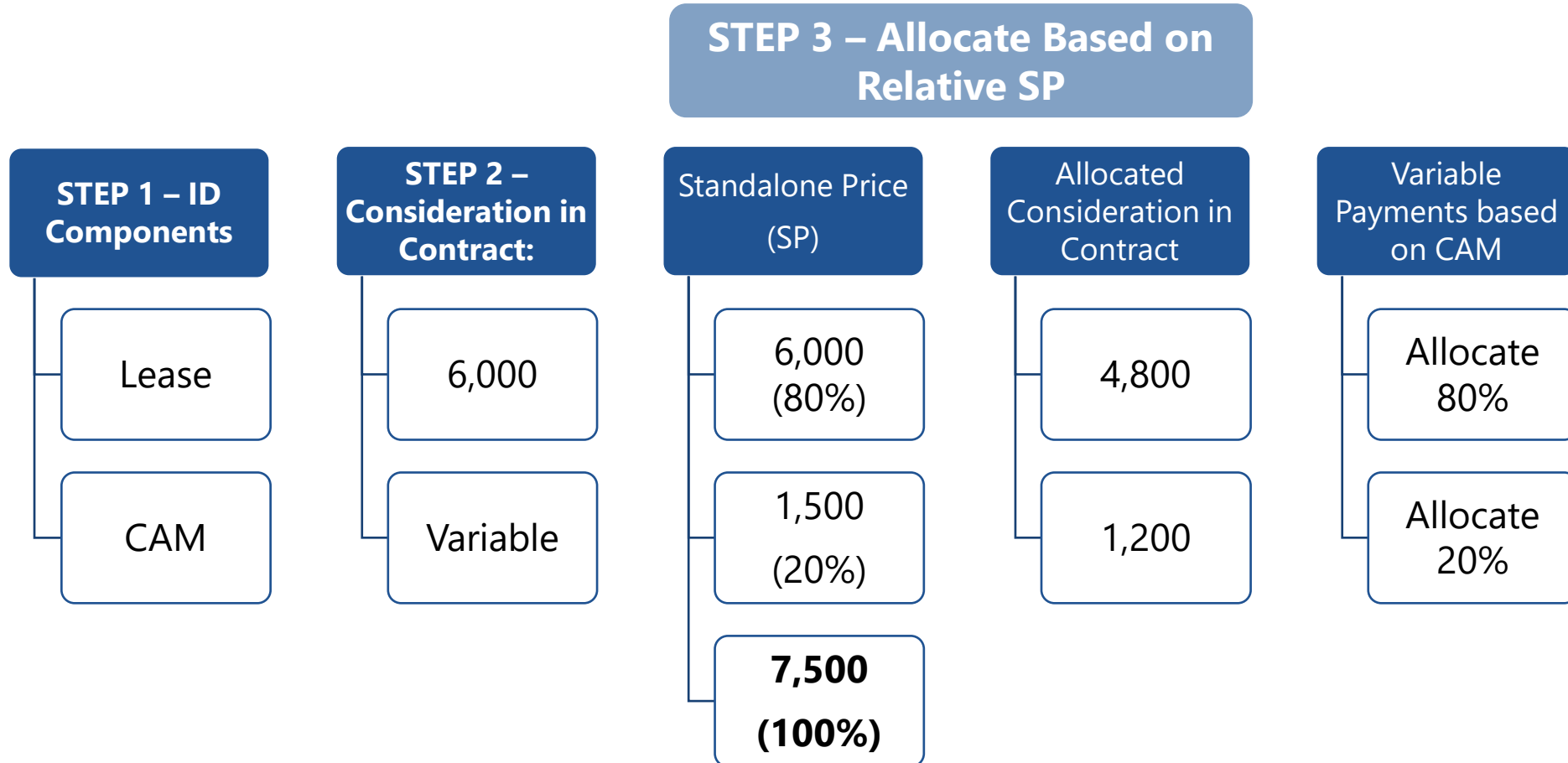
Year	Liability			Residual		Net
	Beg	Payment	End	Beg	Ending	
2020	-	-	(96)	-	06	
2021	(5,006)	(300)		5,006	06	
2022	(4,306)	(258)	1,100	1,006	165	
2023	(3,465)	(208)	1,200		1,172	
2024		(148)	1,300	(1,300)	1,121	
2025	1,200	(70)	1,400	(1,400)	-	
	6,000					

- Book entire payment ... as CAM Expense

ID Units and Allocating Consideration



Lessee – Allocate Consideration in Contract (“Fixed”)



Topic 842 Lessee Allocation

- Fixed - Rent payment equals \$1,000 the first year and increases \$100 each year thereafter. Total payments over 5 years is \$6,000
- CAM – Variable Payments based on actual (expected to be approximate \$300 per year or 1,500 in total)
- Discount rate is 6%

Year	Fixed Payments			Lease Cost Straight Line [a]	Lease Liability				Right of Use Asset		
		Lease	CAM		Beg	Int. (6%)	Payment	End	Beg	Amort.	Ending
		80%	20%			[b]				= [a] - [b]	
2020	-	-	-	-	-	-	-	(4,005)	-	0	4,005
2021	1,000	800	200	960	(4,005)	(240)	800	(3,445)	4,005	(720)	3,285
2022	1,100	880	220	960	(3,445)	(207)	880	(2,772)	3,285	(753)	2,532
2023	1,200	960	240	960	(2,772)	(166)	960	(1,978)	2,532	(794)	1,738
2024	1,300	1,040	260	960	(1,978)	(119)	1,040	(1,057)	1,738	(841)	897
2025	1,400	1,120	280	960	(1,057)	(63)	1,120	0	897	(897)	(0)
	6,000	4,800	1,200	4,800							

Lessee – Let's do the Journal Entries

End of 2020 – Transfer Control of location and establish lease liability and ROU asset

- DR ROU Asset \$4,005 (NPV of allocated fixed payments)
 - CR Lease Liability \$4,005

Lessee – Let's do the Journal Entries

End of 2021 – Accounting for fixed payments

- DR Lease Cost \$240 (*Interest : \$4,005 * 6%*)
- CR Lease Liab. \$240

- DR Lease Cost \$720 (*Amort: 960 - 240*)
- CR ROU Asset \$720

- DR Lease Liab. \$800 (*\$1000 * 80%*)
- DR CAM Expense \$200(*\$1000 * 20%*)
- CR Cash \$1000 (payment per contract)

Lessee – Let's do the Journal Entries

End of 2021 – Accounting for Variable Payments

Actual CAM charges come in at \$298

- DR Lease Cost \$238 ($\$298 * 80\%$)
- DR CAM Expense \$60 ($\$298 * 20\%$)
- CR Cash \$298

Intro to Lease Modifications

Lease Modifications

Separate Contract:

If the lease modification grants the lessee:	
An additional ROU, and	The increase in lease payments commensurate with standalone price

Lease Modifications (continued)

Not a Separate Contract:

Lessee:

Remeasure the lease liability, and if the changes resulted from

an increase in lease term, additional ROU, or change in consideration, then

Adjust ROU asset

a decrease in scope of the lease, then

Recognize Gain/Loss

Topic 842 provides specific guidance on accounting for modifications depending on the nature of the modification (e.g., extension/ reduction of lease term, change in consideration, right to use additional underlying asset)

FASB Example 15 - Modification

Fact Pattern:

- Original - Lessee enters into 10 year lease for 10,000 sqft
- Modification:
 - Beginning of Year 6, the lease is modified to include an **additional 10,000 sqft** for the remainder of the 5 years
 - **Increase in lease payments** for the additional 10,000 sqft is **commensurate with market rate**

Question:

- How do I account for this modification?

FASB Example 15 – New Contract

Fact Pattern:

- Original - Lessee enters into 10 year lease for 10,000 sqft
- Modification:
 - Beginning of Year 6, the lease is modified to include an **additional 10,000 sqft** for the remainder of the 5 years
 - **Increase in lease payments** for the additional 10,000 sqft is **commensurate with market rate**

Question:

- How do I account for this modification?

Answer:

- This is a new contract because there is (1) an increase in ROU and (2) an increase in lease payments that is commensurate with market rates

FASB Example 16 – Term Change

Fact Pattern:

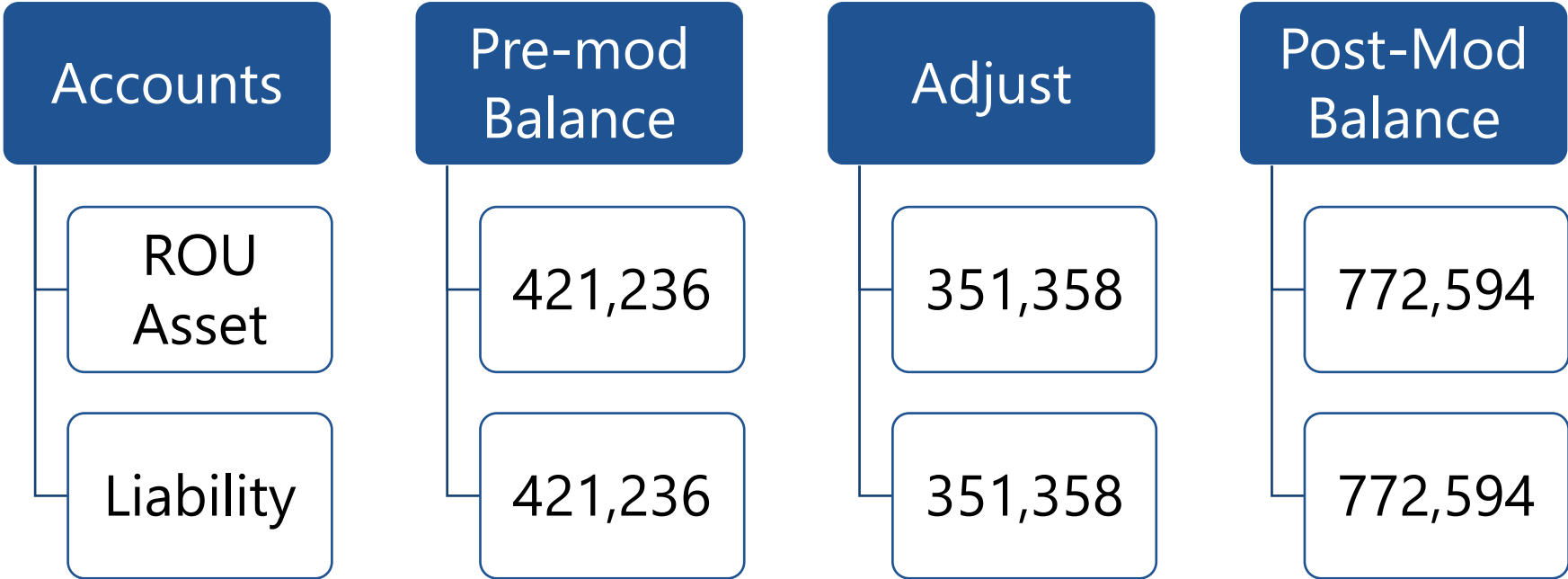
- Original :
 - Lessee enters into 10 year lease for 10,000 sqft
 - Lease payment equal 100,000 per year
 - Original IBR is 6%
- Modification:
 - ROU Asset and Lease Liability balance is 421,236 at modification date
 - Beginning of Year 6 (i.e., 5 years later), the lease is extended for another 5 years (i.e., 15 years in total)
 - Lease payments are now 110,000 for the remaining 10 years
 - IBR at modification is 7%

Question:

- Does the modification change the scope of the ROU asset? In other words does the lessee control more or less space?
- How do I account for this modification?

FASB Example 16 – Term Change

- Not a separate contract.
- Remeasure liability based on remaining payments at new IBR
- The adjustment required to remeasure liability will be offset to ROU Asset
- There is no gain or loss



FASB Example 18 – Decrease in ROU Scope

Fact Pattern:

- Original:
 - 10 year lease for 10,000 sqft
 - Lease payment equals 100,000 per year and increase 5% each year thereafter
 - IBR at lease inception was 6%
- Modification:
 - ROU Asset is 514,436 and Lease Liability is 590,767 right before modification
 - Beginning of Year 6, the lease is modified to reduce leased space from 10,000 sqft to 5000 sqft
 - No change in remaining lease term
 - Lease payment is decreased to 68,000 and then to increase 5% each year thereafter
 - IBR at modification date is 7%
 - Remeasured liability of lease payments at 7% IBR is 306,098

Question:

- Does the modification change the scope of the ROU asset? In other words does the lessee control more or less space?
- How do I account for this modification?

Lease Modifications (continued)

Not a Separate Contract:

Lessee:

Remeasure the lease liability, and if the changes resulted from

an increase in lease term
additional ROU, or change
in consideration, then

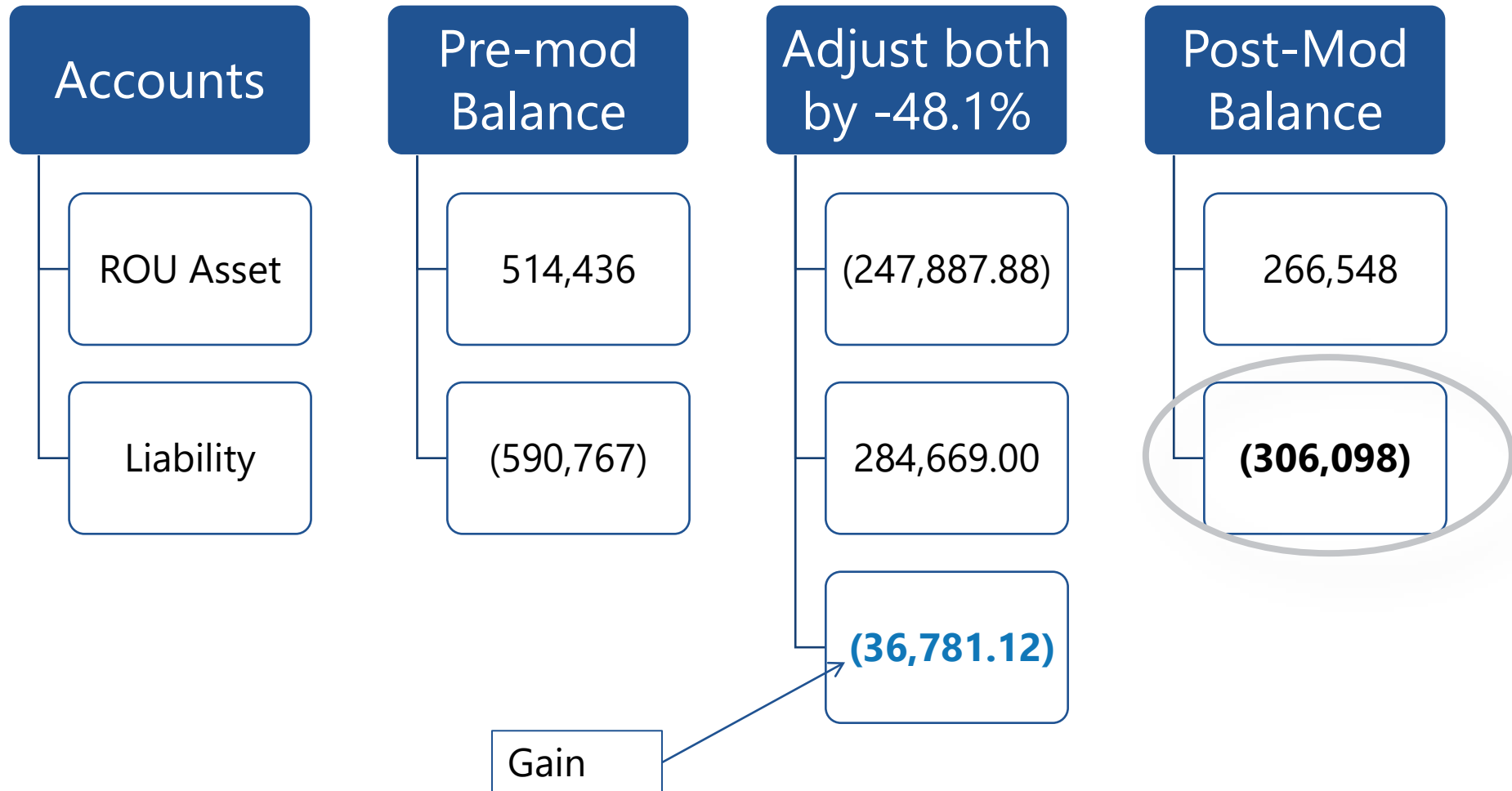
Adjust ROU asset

a decrease in scope of the
lease, then

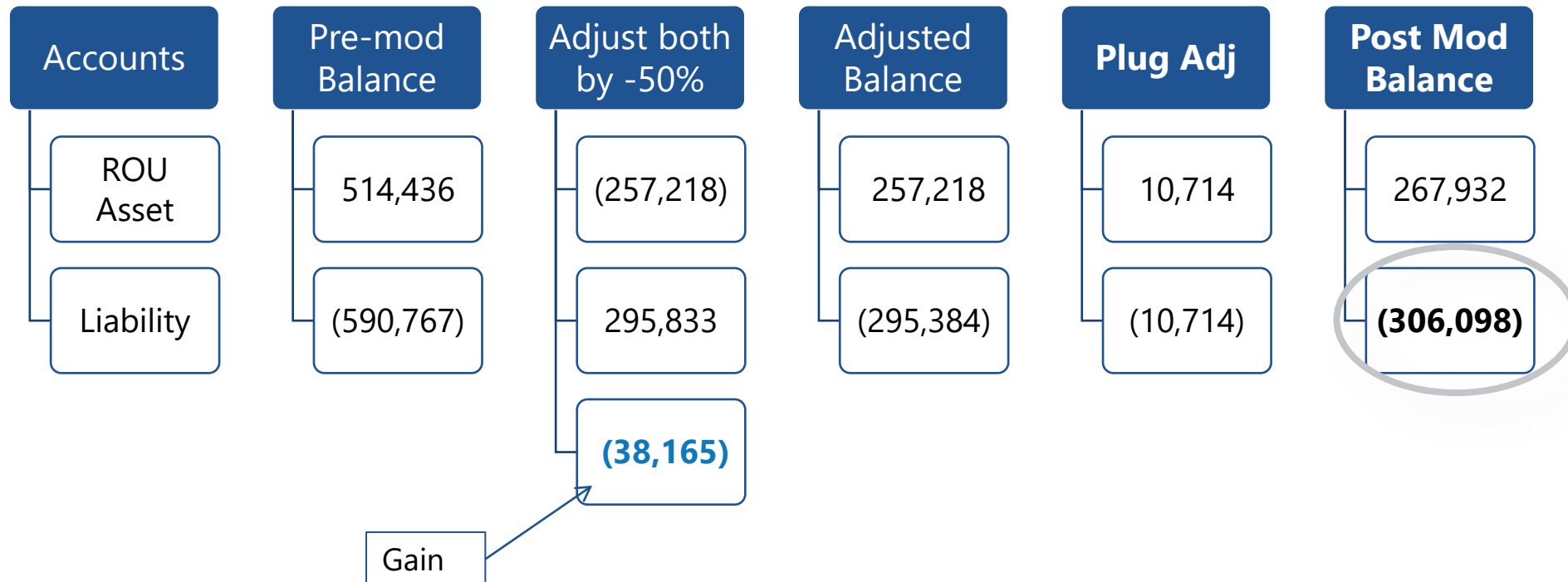
Recognize
Gain/Loss

Topic 842 provides specific guidance on accounting for modifications depending on the nature of the modification (e.g., extension/ reduction of lease term, change in consideration, right to use additional underlying asset)

FASB Example 18 – Liability Approach



FASB Example 18 – ROU Approach



Sale and Leaseback Subtopic 842-40

What is a Sale and Leaseback Transaction?



Sale and Leaseback Overview

Sale occurred?

YES

Apply Sale and
Leaseback

Derecognize asset (gain/loss)
& record leaseback

NO

Failed Sale and
Leaseback

Account as Financing

Sale Occurred?

Sale Occurred? (606-10-25-30)

- Present right to payment
- Legal title
- Physical possession
- Risks and rewards of ownership
- Customer acceptance

Repurchase Option Okay If:

- Option is at market
- Alternative assets substantially the same in marketplace
 - Repurchase option on Real Estate results in failed sale and leaseback because no property is substantially the same

Lease Classification

- Financing precludes sale and leaseback

Successful Sale & Leaseback Accounting

Fair Value based on
what is more
readily
determinable

Off-Market?

Recent
sales?

PV of Market
Rent

If Sales Price
is less than
FV **then** treat
as **Prepaid
Rent**

If Sales Price
is more than
FV **then** treat
excess as
Financing

Sale and Leaseback - At Market

- On December 31, 2020:
 - Seller sells land for \$2 million -> Assume Topic 606 sales criteria is met
 - Observable fair value for the land is also \$2 million
 - Seller's carrying value of land is \$1 million
 - At the same time, Seller leases the land back for 10 years with annual payments of \$120K in arrears
 - Discount Rate is 6%
 - Assume the transaction is classified as an operating lease

Sale and Leaseback - At Market Journal Entries!!!

Group Exercise – Prepare the lease amortization schedule and determine the entries for 2021

Rate 6%

Year	Rent Expense (a)	Lease Liability				Right of Use Asset		
		Beg	Int. (6%) (b)	Payment	End	Beg	Amort. =(a)-(b)	Ending
2020	-	-	-	-	(883,210)	-	-	883,210
2021	120,000	(883,210)	(52,993)	120,000	(816,203)	883,210	(67,007)	816,203
2022	120,000	(816,203)	(48,972)	120,000	(745,175)	816,203	(71,028)	745,175
2023	120,000	(745,175)	(44,711)	120,000	(669,886)	745,175	(75,289)	669,886
2024	120,000	(669,886)	(40,193)	120,000	(590,079)	669,886	(79,807)	590,079
2025	120,000	(590,079)	(35,405)	120,000	(505,484)	590,079	(84,595)	505,484
2026	120,000	(505,484)	(30,329)	120,000	(415,813)	505,484	(89,671)	415,813
2027	120,000	(415,813)	(24,949)	120,000	(320,761)	415,813	(95,051)	320,761
2028	120,000	(320,761)	(19,246)	120,000	(220,007)	320,761	(100,754)	220,007
2029	120,000	(220,007)	(13,200)	120,000	(113,208)	220,007	(106,800)	113,208
2030	120,000	(113,208)	(6,792)	120,000	0	113,208	(113,208)	(0)
10	1,200,000			1,200,000				

Sale and Leaseback - At Market

Record Sale of Land on December 31, 2020

- DR Cash 2,000,000 (Sales price for land)
- CR Land 1,000,000 (Derecognize land)
- CR Gain on Sale 1,000,000 (Sale of land)

Recognize Operating Lease Asset and Liability

- DR ROU Asset 883,210
- CR Lease Liability 883,210

Recognize St. Line Expense & Rent Payment

- DR St. Line Expense 120,000
- CR ROU Asset 67,007
- CR Lease Liability 52,993
- DR Lease Liability 120,000
- CR Cash 120,000

Successful Sale & Leaseback Accounting

Fair Value based on
what is more
readily
determinable

Off-Market?

Recent
sales?

PV of Market
Rent

If Sales Price
is less than
FV **then** treat
as **Prepaid
Rent**

If Sales Price
is more than
FV **then** treat
excess as
Financing

Sale and Leaseback - Selling Price Below FV

- On December 31, 2020:
 - Seller sells land for \$2 million -> Assume sale 606 sales criteria is met
 - Observable fair value for the land is also \$2.3 million
 - Seller's carrying value of land is \$1 million
 - At the same time, Seller leases the land back for 10 years with annual payments of \$120K in arrears
 - Discount Rate is 6%
 - Assume the transaction is classified as an operating lease

Analysis:

- Because sales price is below fair value, the excess in sale price is considered to be prepaid rent
- Results in \$300K of prepaid rent

Sale and Leaseback - SP Below FV

Journal Entries

Why is the ROU Asset 300K more than the liability?

Year	Rent Expense (a)	Lease Liability				Right of Use Asset		
		Beg	Int. (6%) (b)	Payment	End	Beg	Amort. =(a)-(b)	Ending
2020	-	-		-	(883,210)	-	-	1,183,210
2021	150,000	(883,210)	(52,993)	120,000	(816,203)	1,183,210	(97,007)	1,086,203
2022	150,000	(816,203)	(48,972)	120,000	(745,175)	1,086,203	(101,028)	985,175
2023	150,000	(745,175)	(44,711)	120,000	(669,886)	985,175	(105,289)	879,886
2024	150,000	(669,886)	(40,193)	120,000	(590,079)	879,886	(109,807)	770,079
2025	150,000	(590,079)	(35,405)	120,000	(505,484)	770,079	(114,595)	655,484
2026	150,000	(505,484)	(30,329)	120,000	(415,813)	655,484	(119,671)	535,813
2027	150,000	(415,813)	(24,949)	120,000	(320,761)	535,813	(125,051)	410,761
2028	150,000	(320,761)	(19,246)	120,000	(220,007)	410,761	(130,754)	280,007
2029	150,000	(220,007)	(13,200)	120,000	(113,208)	280,007	(136,800)	143,208
2030	150,000	(113,208)	(6,792)	120,000	0	143,208	(143,208)	(0)
10	1,500,000				1,200,000			

Sale and Leaseback - SP Below FV

Journal Entries!!!

Record Sale of Land:

- DR Cash 2,000,000 (Sales price for land)
- DR ROU Asset 300,000 (Prepaid Rent)
 - CR Land 1,000,000 (Derecognize land)
 - CR Gain on Sale 1,300,000 (FV of \$2.3MM less \$1MM)

Record Operating Lease:

- DR ROU Asset 883,211
 - CR Lease Liability 883,211

Sale and Leaseback - SP Below FV

Journal Entries

Operating Lease Entries:

- DR Lease Cost	150,000	
- CR Lease Liab		52,993
- CR ROU Asset		97,007
- DR Lease Liab	120,000	
- CR Cash		120,000

Sale and Leaseback - SP Above FV

- On December 31, 2020:
 - Seller sells land for \$2 million -> Assume sale 606 sales criteria is met
 - Observable fair value for the land is also \$1.4 million
 - Seller's carrying value of land is \$1 million
 - At the same time, Seller leases the land back for 10 years with annual payments of \$120K in arrears
 - Discount Rate is 6%
 - Assume the transaction is classified as an operating lease

Successful Sale & Leaseback Accounting

Fair Value based on
what is more
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Off-Market?

Recent
sales?

PV of Market
Rent

If Sales Price
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Sale and Leaseback - SP Above FV

- On December 31, 2020:
 - Seller sells land for \$2 million -> Assume sale 606 sales criteria is met
 - Observable fair value for the land is also \$1.4 million
 - Seller's carrying value of land is \$1 million
 - At the same time, Seller leases the land back for 10 years with annual payments of \$120K in arrears
 - Discount Rate is 6%
 - Assume the transaction is classified as an operating lease

Analysis:

- Because sales price exceeds fair value, the excess over fair value is considered to be financing
- Results in
 - \$600K financing liability (Sales Price of \$2MM LESS FV of \$1.4MM)
 - \$400K gain (FV of 1.4MM LESS carrying value of \$1MM)

Sale and Leaseback - SP Above FV

Solve for Payment to equal \$600K Financing

Rate 6%

Year	Financing Liability			
	Beg	Int. (6%) (b)	Payment	End
2020	-	-	-	(600,000)
2021	(600,000)	(36,000)	81,521	(554,479)
2022	(554,479)	(33,269)	81,521	(506,227)
2023	(506,227)	(30,374)	81,521	(455,080)
2024	(455,080)	(27,305)	81,521	(400,864)
2025	(400,864)	(24,052)	81,521	(343,395)
2026	(343,395)	(20,604)	81,521	(282,478)
2027	(282,478)	(16,949)	81,521	(217,906)
2028	(217,906)	(13,074)	81,521	(149,460)
2029	(149,460)	(8,968)	81,521	(76,906)
2030	(76,906)	(4,614)	81,521	-

Years 10

815,207

Analysis:

- Total Payment of **120,000** is comprised of:
 - Group Exercise**
 - Excel File under header "Sale & Leaseback – Financing Liability"
 - Use **PMT function** in Excel to determine payment needed
 - \$81,521** - Calculated as 10 years discounted at 6% to equal financing of 600,000)
 - \$38,479** related to the lease payment

Sale and Leaseback - SP Above FV

Account for the Operating Lease

Analysis:

- Calculation of **\$38,479** related to the lease payments results in the following:

Year	Rent Expense (a)	Lease Liability				Right of Use Asset		
		Beg	Int. (6%) (b)	Payment	End	Beg	Amort. =(a)-(b)	Ending
2020	-	-	-	-	(283,211)	-	-	283,211
2021	38,479	(283,211)	(16,993)	38,479	(261,725)	283,211	(21,487)	261,725
2022	38,479	(261,725)	(15,703)	38,479	(238,949)	261,725	(22,776)	238,949
2023	38,479	(238,949)	(14,337)	38,479	(214,806)	238,949	(24,142)	214,806
2024	38,479	(214,806)	(12,888)	38,479	(189,215)	214,806	(25,591)	189,215
2025	38,479	(189,215)	(11,353)	38,479	(162,089)	189,215	(27,126)	162,089
2026	38,479	(162,089)	(9,725)	38,479	(133,335)	162,089	(28,754)	133,335
2027	38,479	(133,335)	(8,000)	38,479	(102,856)	133,335	(30,479)	102,856
2028	38,479	(102,856)	(6,171)	38,479	(70,548)	102,856	(32,308)	70,548
2029	38,479	(70,548)	(4,233)	38,479	(36,301)	70,548	(34,246)	36,301
2030	38,479	(36,301)	(2,178)	38,479	0	36,301	(36,301)	(0)

Sale and Leaseback - SP Above FV

Journal Entries

Record Sale of Land:

- DR Cash 2,000,000 (Sales price for land)
- CR Land 1,000,000 (Derecognize land)
- CR Gain on Sale 400,000 (FV of \$1.4MM less \$1MM)
- CR Debt 600,000 (Excess over FV)

Record Operating Lease:

- DR ROU Asset 283,211
- CR Lease Liability 283,211 (PV of 38,479 pmt)

Sale and Leaseback - SP Above FV

Journal Entries

What is this for?

- DR Interest Expense	36,000
- CR Debt	36,000

What about this?

- DR Lease Cost	38,479
- CR Lease Liab	16,993
- CR ROU Asset	21,487

Where did I get the 81,521 and 38,479 from?

- DR Debt	81,521
- DR Lease Liab	38,479
- CR Cash	120,000

Failed Sale and Leaseback

Transfer is not a sale (842-40-25-5)

- Seller-Lessee shall not derecognize transferred asset
- Amounts received are accounted as a financial liability

Interest Rate Must Adjusted If (842-40-30-6):

- Interest on Financial Liability is greater than Payments over the shorter of the lease term or financing
- Carrying Amount of asset exceeds the Financial Liability

Failed Sale and Leaseback - Example

- On December 31, 2020:
 - Seller sells a building for \$10 million -> Assume sale 606 sales criteria is met
 - Seller's carrying value of building is \$9 million
 - Building has a remaining useful life of 30 years at date of transfer
 - At the same time, Seller leases the building back:
 - For 5 years
 - Annual payments of \$750K in arrears
 - Incremental borrowing rate is 6%
 - Seller has the option to purchase the building back at fair value at the end of the lease term

Failed Sale and Leaseback - Example

- On December 31, 2020:
 - Seller sells a building for \$10 million -> Assume sale 606 sales criteria is met
 - Seller's carrying value of building is \$9 million
 - Building has a remaining useful life of 30 years at date of transfer
 - At the same time, Seller leases the building back:
 - For 5 years
 - Annual payments of \$750K in arrears
 - Incremental borrowing rate is 6%
 - Seller has the option to purchase the building back at fair value at the end of the lease term

Question:

- Why is does this transaction fail sale and leaseback treatment?

Failed Sale and Leaseback - Example

Go to Excel file under header "Failed Sale & Leaseback:"

6.00%

Year	Financing				Building Value		
	Beg	Int. (a)	Payment	End	Beg	Amort. (b)	Ending
2020	-	-	-	(10,000,000)	-	-	9,000,000
2021	(10,000,000)	(600,000)	750,000	(9,850,000)	9,000,000	(300,000)	8,700,000
2022	(9,850,000)	(591,000)	750,000	(9,691,000)	8,700,000	(300,000)	8,400,000
2023	(9,691,000)	(581,460)	750,000	(9,522,460)	8,400,000	(300,000)	8,100,000
2024	(9,522,460)	(571,348)	750,000	(9,343,808)	8,100,000	(300,000)	7,800,000
2025	(9,343,808)	(560,628)	750,000	(9,154,436)	7,800,000	(300,000)	7,500,000

Total (2,904,436) 3,750,000

Failed Sale and Leaseback - Example

Record Sale of Building as Financing on December 2020

- DR Cash 10,000,000 (proceeds from transfer)
 - CR Financial Liab 10,000,000

For year 2021:

- DR Depr Exp 300,000 (3,000,000 over 30 years)
 - CR Accum Depr 300,000
- DR Interest Exp 600,000 (10MM * 6%)
 - CR Financial Liab 600,000
- DR Financial Liab. 750,000 (Payment per lease)
 - CR Cash 750,000

Failed Sale and Leaseback - Example

End of 2025 – purchase option is not exercised

- DR Financial Liab 9,154,436 (balance when lease ends)
- CR Building 7,500,000 (CV when lease ends)
- Gain on Sale 1,654,436

Failed Sale and Leaseback - Example - Interest too High!

- On December 31, 2020:
 - Seller sells a building for \$10 million -> Assume sale 606 sales criteria is met
 - Seller's carrying value of building is \$9 million
 - Building has a remaining useful life of 30 years at date of transfer
 - At the same time, Seller leases the building back:
 - For 5 years
 - Annual payments of \$750K in arrears
 - **Incremental borrowing rate is 9%**
 - Seller has the option to purchase the building back at fair value at the end of the lease term

Failed Sale and Leaseback - Example - Interest too High!

Task - Update the schedule to reflect a 9% IBR...

- What do you notice about the liability by the end of the lease?
- If nothing is changed what would this result in when the lease ends?

9%

Year	Lease Liability				Building Value		
	Beg	Int. (a)	Payment	End	Beg	Amort. (b)	Ending
2020	-	-	-	(10,000,000)	-	-	9,000,000
2021	(10,000,000)	(900,000)	750,000	(10,150,000)	9,000,000	(300,000)	8,700,000
2022	(10,150,000)	(913,500)	750,000	(10,313,500)	8,700,000	(300,000)	8,400,000
2023	(10,313,500)	(928,215)	750,000	(10,491,715)	8,400,000	(300,000)	8,100,000
2024	(10,491,715)	(944,254)	750,000	(10,685,969)	8,100,000	(300,000)	7,800,000
2025	(10,685,969)	(961,737)	750,000	(10,897,707)	7,800,000	(300,000)	7,500,000

Total (4,647,707) 3,750,000

Failed Sale and Leaseback - Example - Interest too High!

Transfer is not a sale (842-40-25-5)

- Seller-Lessee shall not derecognize transferred asset
- Amounts received are accounted as a financial liability

Interest Rate Must Adjusted If (842-40-30-6):

- Interest on Financial Liability is greater than Payments over the shorter of the lease term or financing
- Carrying Amount of asset exceeds the Financial Liability

Failed Sale and Leaseback - Example - Interest too High!

Interest rate has been updated so that interest expense will not exceed payments

- What will happen in the end now?
- What will the gain or loss be?

7.5%

Year	Lease Liability			
	Beg	Int. (a)	Payment	End
2020	-	-	-	(10,000,000)
2021	(10,000,000)	(750,000)	750,000	(10,000,000)
2022	(10,000,000)	(750,000)	750,000	(10,000,000)
2023	(10,000,000)	(750,000)	750,000	(10,000,000)
2024	(10,000,000)	(750,000)	750,000	(10,000,000)
2025	(10,000,000)	(750,000)	750,000	(10,000,000)

Building Value		
Beg	Amort. (b)	Ending
-	-	9,000,000
9,000,000	(300,000)	8,700,000
8,700,000	(300,000)	8,400,000
8,400,000	(300,000)	8,100,000
8,100,000	(300,000)	7,800,000
7,800,000	(300,000)	7,500,000

Total (3,750,000) 3,750,000

Failed Sale and Leaseback - Example – Carrying Amount too High!

- On December 31, 2020:
 - Seller sells a building for \$10 million -> Assume sale 606 sales criteria is met
 - Seller's carrying value of building is \$9 million
 - Building has a remaining useful life of 30 years at date of transfer
 - At the same time, Seller leases the building back:
 - For 5 years
 - Annual payments of \$750K in arrears
 - **Incremental borrowing rate is 2%**
 - Seller has the option to purchase the building back at fair value at the end of the lease term

Failed Sale and Leaseback - Example - Carrying Amount too High!

Task - Update the schedule to reflect a 2% IBR...

- Does the Carrying Value exceed the liability?
- If nothing is changed what would this result in when the lease ends?

2.00%

Year	Lease Liability				Building Value		
	Beg	Int. (a)	Payment	End	Beg	Amort. (b)	Ending
2020	-	-	-	(10,000,000)	-	-	9,000,000
2021	(10,000,000)	(200,000)	750,000	(9,450,000)	9,000,000	(300,000)	8,700,000
2022	(9,450,000)	(189,000)	750,000	(8,889,000)	8,700,000	(300,000)	8,400,000
2023	(8,889,000)	(177,780)	750,000	(8,316,780)	8,400,000	(300,000)	8,100,000
2024	(8,316,780)	(166,336)	750,000	(7,733,116)	8,100,000	(300,000)	7,800,000
2025	(7,733,116)	(154,662)	750,000	(7,137,778)	7,800,000	(300,000)	7,500,000

Total (887,778) 3,750,000

Failed Sale and Leaseback - Example - Carrying Amount too High!

Transfer is not a sale (842-40-25-5)

- Seller-Lessee shall not derecognize transferred asset
- Amounts received are accounted as a financial liability

Interest Rate Must Adjusted If (842-40-30-6):

- Interest on Financial Liability is greater than Payments over the shorter of the lease term or financing
- **Carrying Amount of asset exceeds the Financial Liability**

Failed Sale and Leaseback - Example - Carrying Amount too High!

Need to solve for the rate so carrying value does not exceed financial liability

- Use "Goal Seek" function (*Data > What-If Analysis > Goal Seek*)
- What will happen in the end now?
- What will the gain or loss be?

2.77%

Year	Lease Liability				Building Value		
	Beg	Int. (a)	Payment	End	Beg	Amort. (b)	Ending
2020	-	-	-	(10,000,000)	-	-	9,000,000
2021	(10,000,000)	(276,937)	750,000	(9,526,937)	9,000,000	(300,000)	8,700,000
2022	(9,526,937)	(263,837)	750,000	(9,040,774)	8,700,000	(300,000)	8,400,000
2023	(9,040,774)	(250,373)	750,000	(8,541,147)	8,400,000	(300,000)	8,100,000
2024	(8,541,147)	(236,536)	750,000	(8,027,683)	8,100,000	(300,000)	7,800,000
2025	(8,027,683)	(222,317)	750,000	(7,500,000)	7,800,000	(300,000)	7,500,000

Total (1,250,000) 3,750,000

Questions?