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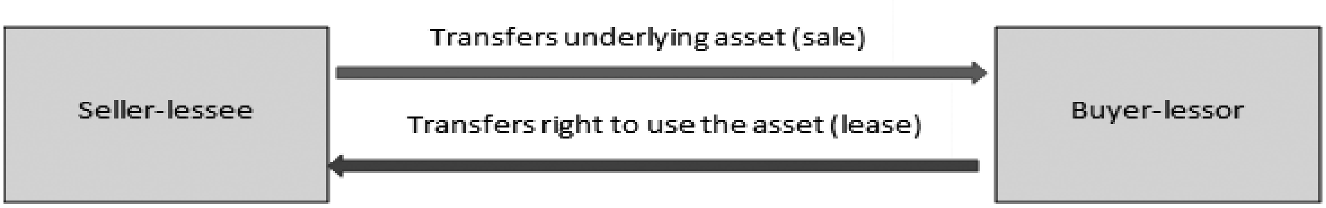
Sale & Leaseback Transactions Accounting Refresher

The changing interest rate environment, tight capital market, and opportunity to monetize asset appreciation are now making sale and leaseback transactions more economically viable. If your company has recently completed a transaction or is contemplating a deal, be aware that the accounting for sale leasebacks was modified with the issuance of Accounting Standards Codification (ASC) 842, *Leases*. To qualify for day-one gains on a sale and leaseback transaction, certain criteria have to be met. Here is a refresher and a helpful decision tree.

Overview

The number of sale and leaseback transactions has rebounded and continued growth is expected in 2025. Some headline deals in 2024 include Life Time Fitness, $40 million;[1] Red Robin, $24 million;[2] and Douglas Dynamics, $64 million.[3]

In a sale and leaseback transaction, one party (the seller-lessee) sells an asset it owns to another party (the buyer-lessor) and immediately leases back all or a portion of that asset. ASC 842 updated the guidance for sale and leaseback transactions, making it applicable to both lessees and lessors and applying it consistently to real estate and other types of assets. Benefits to the seller-lessee include an inflow of cash and—for qualifying transactions—the ability to recognize the gain on the transaction date, which makes sales and leaseback transactions particularly appealing.



Accounting outcomes will depend on the economics and structure of the transaction. The issuance of ASC 606, *Revenue from Contracts with Customers,* and ASC 842 updated sale and leaseback guidance and the criteria to be met so that seller-lessees can recognize the gain on the date of the sale. For sale-leaseback accounting to apply:

A. The transaction must qualify as a sale under ASC 606, and the buyer-lessor must obtain control of the asset.

B. The leaseback must not be classified as finance lease (seller-lessee) or sale-type lease (buyer-lessor).

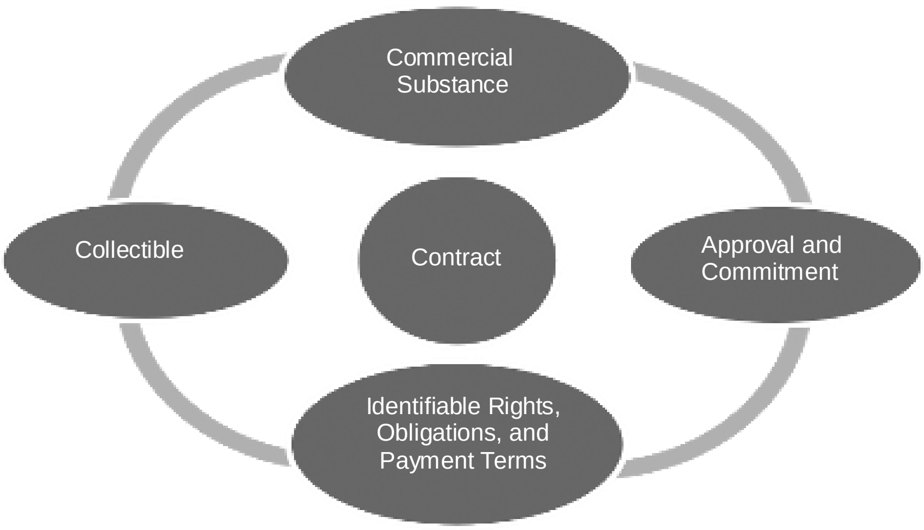
C. If there is a repurchase option, it must meet two criteria mentioned below.

[1]"Life Time Closes on $40 Million Sale-Leaseback Transaction," news.lifetime.life, May 29, 2024.
[2]"Red Robin Gourmet Burgers, Inc. Completes Third Sale-Leaseback Transaction With Essential Properties Realty Trust, Inc.," ir.redrobin.com, March 4, 2024.
[3]"Douglas Dynamics Completes $64.2 Million Sale-Leaseback Transaction with TPG Angelo Gordon," tpg.com, September 11, 2024.

A. Has a Sale Occurred?

Contract Existence Criteria

The following graphic highlights the conditions to be met to determine if a contract exists. Once these conditions are met, the transfer of control also must be evaluated.



Control

ASC 606 lists five indicators that a customer has obtained control of an asset:

- **Present right to payment**. If a customer presently is obliged to pay for an asset, that may indicate that the customer has obtained the ability to direct the use of—and obtain substantially all of the remaining benefits from—the asset in exchange. The upfront payment by the customer (buyer-lessor) for the leased asset generally satisfies this indicator.
- **Legal title**. Legal title may indicate which party to a contract has the ability to direct the use of—and obtain substantially all of the remaining benefits from—an asset or to restrict the access of other entities to those benefits. The transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
- **Physical possession**. The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of—and obtain substantially all of the remaining benefits from—the asset or to restrict the access of other entities to those benefits.
- **Significant risks and rewards of ownership**. The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of—and obtain substantially all of the remaining benefits from—the asset.

- **Asset accepted**. The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of—and obtain substantially all of the remaining benefits from—the asset.

Not all of the above factors have to be met for control to have been transferred. Management judgment is required to assess all the factors together. The assessment should be made from the buyer/lessor's perspective.

B. Lease Classification

Under ASC 842, for lessees, leases are classified as either financing or operating. The leaseback must be an operating lease to be eligible for qualified sale accounting.

Under ASC 842-10-25-2, if a lease meets any of the conditions below, the lease substantially transfers all risks and rewards incidental to ownership and will be classified as a finance lease (from a lessee's standpoint) and a sales-type lease (from a lessor's standpoint). A lease that does not meet any of the criteria does not effectively transfer control to the lessee and would be classified as an operating lease by the lessee and either an operating lease or direct financing lease by the lessor.

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise (bargain purchase option).
- The lease term is for a major part of the economic life of the underlying asset; if the commencement date falls at or near the end of the leased asset's economic life, this criterion shall not be used to classify the lease.
- The present value of minimum lease payments and residual value guarantee by the lessee is equal to or more than substantially all the leased asset's fair value.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

The fifth item is new for lessors and lessees under ASC 842. In assessing if an underlying asset has an alternative use to the lessor, an entity should consider the effects of enforceable contractual restrictions and practical limitations (incurring significant losses, unique lessee design specifications, or remote locations) on the lessor's ability to readily direct the asset for another use, *e.g.*, selling or leasing it to an entity other than the lessee. The assessment of alternative use may be made in conjunction with the assessment of a bargain purchase option. In these cases, the terms and conditions of a purchase option that is exercisable at the end of an extension period may be set at a rate that is significantly discounted from the expected market value, making it reasonably certain that the lessee will exercise the purchase option (leaving no alternative use for the lessor).

C. Asset Repurchase Option

Per ASC 842-40-25-1, a repurchase option does not preclude sale and leaseback accounting if both of the following criteria are met:

- The exercise price of the option is the fair value of the asset at the time the option is exercised.

- There are alternative assets—substantially the same as the transferred asset—readily available in the marketplace.

Fixed price repurchase options preclude sale and leaseback accounting. In addition, if the underlying asset is real estate, the transaction would most likely fail to meet the second criterion because each location is unique and alternative real estate assets would not be considered “substantially the same.”

Qualified Sale Accounting

A qualified sale and leaseback would be treated as two separate transactions—the sale (seller-lessee) or purchase (buyer-lessor) and lease under ASC 842.

The seller-lessee will derecognize the asset and recognize entire gain or loss at the time of the sale, subject to any adjustments for off-market terms.

The buyer-lessor will recognize purchase of the underlying asset as purchase of any other nonfinancial asset, subject to any adjustments for off-market terms.

Off-Market Terms

The sale should be recognized at fair value and some adjustments may be needed if the transaction is entered into at off-market terms. Under ASC 842, an entity shall use the difference between either of the following—whichever is more readily determinable—to evaluate if the sale is at fair value:

- The asset’s sale price and fair value
- The present value of the lease payments and market rental payments

If the sale and leaseback transaction is not at fair value, ASC 842-40-30-2 requires an entity to account for both of the following:

- Any increase to the sale price of the asset as a prepayment of rent.
- Any reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and buyer-lessor shall account for the additional financing in accordance with other topics.

A sale and leaseback transaction is not off market solely because the sale price or lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) based on all the information—historical, current, and forecast—that is reasonably available to the entity. For a seller-lessee, this would include estimating any variable consideration to which it expects to be entitled.

Failed Sale

If the criteria for a qualified sale are not met, the transaction must be accounted for as a financing transaction by the seller-lessee and a lending transaction by the buyer-lessor. The seller-lessee would not derecognize the underlying asset and would continue depreciating the asset. A financial liability should be recognized for the sales proceeds received from the buyer-lessor. The seller-lessee's rental payments would be allocated between interest expense and principal repayment of the financial liability, using the seller-lessee's incremental borrowing rate to calculate the interest portion.

Conclusion

The application of provisions for sale and leaseback can be complex, requiring careful considerations of the relevant accounting rules and transaction specifics. If you have any questions or need assistance, please reach out to a professional at Forvis Mazars.

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Appendix – Decision Tree

The following decision tree summarizes the basic guidance for a sale and leaseback transaction.