Practice Questions

Question 01 – SLFRS 16

Sale and leaseback

On 1 January 20X7, Benito Co sold its head office which had a carrying amount of $3·75 million to Otine Co for cash of $7·5 million. On the same date, Benito Co has entered into a contract with Otine Co to use the head office for 20 years, with annual payments payable at the end of each year. Both companies have correctly accounted for the transaction as a sale and leaseback.

At 1 January 20X7, the fair value of the head office is $6·75 million. The present value of the annual lease payments is $5·47 million.

Key performance indicators (KPIs)

A sale and leaseback transaction allows selling companies to free up cash, improve liquidity and redeploy capital into core activities. The decision as regards whether the sale and leaseback can be treated as a sale under IFRS 15 *Revenue from Contracts with Customers* can significantly affect Benito Co's KPIs and profitability, therefore affecting an investor's view of the assets which Benito Co is using and the liabilities which it has. The following KPIs of Benito Co will be affected by this decision:

KPI	Calculation
Gearing	Debt/equity
EBIT	Earnings before interest and tax
Asset turnover	Sales/total assets
Return on capital employed (ROCE)	EBIT/equity plus financial liabilities

Requirements

a) In accordance with IFRS Accounting Standards:

explain the effect on the accounting treatment if a sale and leaseback agreement contain a call option under which the seller-lessee can, at its option, repurchase the property.

(b) Using exhibit 1, explain in accordance with IFRS 16, the accounting entries for the sale and leaseback transaction in the financial statements of Benito Co on 1 January 20X7 if the head office transfer:

- **qualifies as a 'sale'; and**
- **does not qualify as a 'sale'.** **(7 marks)**

(c) Using exhibit 1, compare the impact of the head office transfer qualifying as a 'sale' and not qualifying as a 'sale' on Benito Co's financial statements and key performance indicators (KPIs). (7 marks)

Two professional marks will be awarded in part (c) for the quality of the discussion regarding the effects on the financial statements and the specific KPIs. (2 marks)

(a)

If the transaction contains a call option under which the seller-lessee can, at its option, repurchase the property, then such an option generally precludes sale accounting under IFRS 15. This is because the existence of the call option means that the seller-lessee retains control of the property. Therefore, sale and leaseback accounting does not apply, with the asset remaining on the statement of financial position and the cash received treated as a financial liability.

(b) Head office transfer qualifies as a sale

Because the consideration for the sale of the head office is not at fair value, Benito Co recognises the \$0·75 million excess over fair value (\$7·5m – \$6·75m) as additional financing provided by Otine Co. The present value of the annual payments amounts to \$5·47 million of which \$0·75 million (\$7·5m – \$6·75m) relates to the additional financing and \$4·72 million (\$5·47m – \$0·75m) relates to the lease.

At 1 January 20X7, Benito Co measures the RoU asset arising from the leaseback of the building at the proportion of the previous carrying amount of the head office which relates to the right of use retained. This is calculated as \$3·75 million (the carrying amount of the head office) ÷ \$6·75 million (the fair value of the building) x \$4·72 million (the discounted lease payments for the RoU asset), that is \$2·62 million.

Benito Co recognises only the amount of the gain which relates to the rights transferred to Otine Co. The gain on sale is \$3million (\$6·75m – \$3·75m), of which \$2·1 million (\$3m ÷ \$6·75m x \$4·72m) relates to the right to use the head office retained by Benito Co. The rights transferred to Otine Co are measured at \$0·9 million (\$3m ÷ \$6·75m x (\$6·75m – \$4·72m)).

At 1 January 20X7, Benito Co accounts for the transaction as follows.

	Dr	Cr
	$m	**$m**
Cash	7·50	
RoU asset	2·62	
Property, plant and equipment		3·75
Liabilities (lease liability and financial liability)		5·47
Gain on rights transferred (SOPL)		0·90

Head office transfer does not qualify as a sale

The head office will continue to be recognised by Benito Co at its carrying amount of $3 ·75 million. A financial liability is recognised equal to the transfer proceeds of $7 ·5 million.

	Dr	Cr
	$m	$m
Cash	7 ·5	
Financial liability		7 ·5

Answer

The decision as regards whether the sale and leaseback can be treated as a sale under IFRS 15 can significantly affect performance ratios. If the sale and leaseback cannot be treated as a sale under IFRS 15, the gross assets and liabilities will be greater for the seller-lessee as the asset remains on the statement of financial position and the cash received is treated as a financial liability. Total debt will be higher and this may have an impact with loan covenants based on total debt levels as it may lead to breaches.

The difference in treatment will also affect some profitability ratios because of two elements: the depreciation and the interest charge. The depreciation and interest charge will be higher in this case as the carrying amount of the property is recorded at a higher value than the RoU asset and the interest charge will be higher as the financial liability is higher than the lease liability. Also, there will be no gain recorded on the sale of the asset, thus reducing profit.

KPI	Calculation	Effect of sale and leaseback on KPI if the transaction is NOT a sale
Gearing	Debt/equity	Gearing will be higher because the financial liability of $7·5 million is greater than the combined lease and financial liability of $5·47 million.
EBIT	Earnings before interest and tax	EBIT will be lower because of a higher depreciation charge (based on original carrying amount of $3·75 million rather than RoU asset of $2·62 million) and no gain on sale. Interest has no impact on EBIT.
Asset turnover	Sales/total assets	Asset turnover will be lower because the property remains on SOFP at its carrying amount of $3·75 million. This is higher than the RoU asset of $2·62 million if the transfer is a sale.
Return on capital employed (ROCE)	EBIT/equity plus financial liabilities	ROCE will be lower because EBIT will be lower. Also, financial liabilities will be higher if the asset is not sold. If the transfer is a sale, equity will be higher because of the gain on sale and the reduced deprecation, but also EBIT will be higher