

# Statutory Issue Paper No. 22

## Leases

### STATUS

Finalized March 16, 1998

**Original SSAP and Current Authoritative Guidance: SSAP No. 22**

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. Current statutory accounting guidance provides only limited guidance on the accounting for leases and does not clearly differentiate capital and financing leases from operating leases. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies state that the form of lease agreements should determine the accounting. However, the manuals also state that lease-purchase transactions should be accounted for in accordance with their substance. Both sections state that GAAP is commonly used as a guideline where not in conflict with statutory accounting principles. This guidance generally has been interpreted to prescribe operating lease treatment for all leases, but to allow sales-type lease treatment by lessors if the criteria established in GAAP are met.

2. The purpose of this issue paper is to establish statutory accounting principles for leases by lessors and lessees that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It addresses:

- Accounting and reporting by lessees
- Accounting and reporting by lessors
- Sale-leaseback transactions
- Leveraged leases for lessors
- Related party leases
- Disclosures

### SUMMARY CONCLUSION

3. For purposes of statutory accounting principles, a lease is defined as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other (i.e., employee lease contracts). On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of statutory accounting principles even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.

### Accounting and Reporting by Lessees

4. All leases shall be considered operating leases. Rent on an operating lease shall be charged to expense over the lease term as it becomes payable, except as provided in paragraphs 5 and 6.

5. As discussed in *FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases*, the effects of scheduled rent increases normally shall be recognized on a straight-line basis over the lease term.

6. Lease agreements may also include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee's preexisting lease. As discussed in *FASB Technical Bulletin 88-1, Issues Relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease; Lease Incentives in an Operating Lease; Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor; Money-Over-Money Lease Transactions; Wrap Lease Transactions*, incentives paid to or payments made on behalf of the lessee shall be considered reductions of minimum lease payments (i.e., the payments that the lessee is obligated to make or can be required to make in connection with the leased properties.) These incentives shall be recognized over the lease term on a straight-line basis unless the use of another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. (The lessee's immediate recognition of expenses or losses (e.g., moving costs, losses on subleases, write-offs of leasehold improvements) shall not be changed by this guidance.)

### **Accounting and Reporting by Lessors**

7. All leases, except leveraged leases as defined in paragraph 14, shall be considered operating leases and accounted for by the lessor as follows:

- a. The leased property shall be included in the same balance sheet category it would be had the property not been leased. The property shall be depreciated following the lessor's normal depreciation policies for such assets.
- b. Rental income shall be reported as investment income as it becomes receivable according to the provisions of the lease. However, as discussed in paragraphs 5 and 6 of this issue paper, rentals may be recognized before they become due, if rentals vary from the straight-line basis. The guidance in *Issue Paper No. 34—Investment Income Due and Accrued* shall be applied to the receivable balance.
- c. Initial direct costs shall be charged to expense when incurred, and shall not be deferred and allocated over the lease term. Initial direct costs are those incremental costs that the lessor has incurred in directly evaluating, negotiating, administering, and closing a lease transaction.

8. The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, shall not be treated as a sale if the seller or any party related to the seller (related party is defined in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties* (Issue Paper No. 25) retains substantial risks of ownership in the leased property.

### **Sale-Leaseback Transactions**

9. Sale-leaseback transactions involve the sale of property, plant, or equipment by the owner and a lease of the asset back to the seller. Sale-leaseback accounting, whereby the seller-lessee records the sale, removes the assets and related liabilities from its balance sheet, and accounts for the lease in accordance with the guidance in paragraphs 4-6 of this issue paper, shall be used by the seller-lessee for sale-leaseback transactions only if the transaction includes all of the following:

- a. A normal leaseback (see paragraph 11)
- b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (see paragraph 12)
- c. Payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee (see paragraph 12)

- d. Admitted assets, if the buyer-lessor is a related party, or either admitted or nonadmitted assets if the buyer-lessor is not a related party. For purposes of this paragraph, related parties include those identified in Issue Paper No. 25 and entities created for the purpose of buying and leasing nonadmitted assets for the reporting entity and/or its affiliates.

When applying sale-leaseback accounting, the sale, and gains or losses thereon, shall be recognized in accordance with the relevant statutory guidance for the asset being sold. For example, sales of real estate shall be accounted for in accordance with *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40), which adopts *FASB Statement No. 66, Accounting for Sales of Real Estate* (FAS 66).

10. If criteria a., b., or c. in paragraph 9 are not met the sale of the asset shall be accounted for as a financing or deposit in accordance with FAS 66, which was adopted in Issue Paper No. 40. If criteria 9 d. is not met, the deposit method shall be used. Under the deposit method, the seller recognizes no profit or loss on the sale, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer. Lease payments decrease and collections on the buyer-lessors note, if any, increase the seller-lessees deposit account. The property and related debt continue to be in the seller-lessees balance sheet, and the seller-lessee continues to depreciate the property. Also, a loss shall be recognized by the seller-lessee, if, at any reporting date, the net admitted value of the leased asset exceeds the sum of the balance in the deposit account, the fair value of the unrecorded note receivable, and any debt assumed by the buyer. Under the financing method, the asset will continue to be carried as an admitted asset. The proceeds from the sale are recognized as a borrowing (liability) and equated to the present value of the leaseback rents to determine the interest rate to use to accrue interest on the debt. If there is a change in lease terms such that the sale-leaseback transaction subsequently qualifies for sale-leaseback accounting recognition, sale-leaseback accounting as described in paragraph 9 shall be applied as if the sale had been recognized at the inception of the lease. Otherwise at the end of the lease term any deferred profit shall be recognized.

11. A normal leaseback in the context of a real estate sale-leaseback shall be defined as a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee, and excludes other continuing involvement provisions.

12. A continuing involvement provision shall be defined as involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Examples of continuing involvement are as follows:

- a. The seller-lessee has an obligation or an option to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.
- b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time.
- c. The seller-lessee is required to pay the buyer-lessor at the end of the lease term for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.
- d. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.
- e. The seller-lessee is not relieved of the obligation under any existing debt related to the property.

- f. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.
- g. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.
- h. The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.

13. The buyer-lessor shall account for the purchase in accordance with applicable statutory guidance for the asset acquired and lease in accordance with paragraphs 7-8 of this issue paper.

#### **Leveraged Leases for Lessors**

14. Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially "leveraged" in the transaction), property, plant or equipment with the intentions to lease the asset(s) to the lessee. Leveraged leases shall be defined as those leases that meet the criteria set forth in paragraph 42.a. through 42.d. (and the related paragraphs to which 42 refers) of *FASB Statement No. 13, Accounting for Leases* (FAS 13) as amended and interpreted. Leases which meet the preceding definition shall be accounted for in accordance with paragraphs 43-47 (and the related paragraphs to which 43-47 refer) of FAS 13. The lessor shall record its investment net of the nonrecourse debt. In cases where the asset being leased is a nonadmitted asset, any net leveraged lease asset shall be nonadmitted.

#### **Related-Party Leases**

15. This issue paper applies to arms-length transactions. To the extent that leases between related parties are, in substance, arms-length transactions the guidance in this issue paper shall be applied. The determination of whether related party leases qualify as arms length transactions will be addressed in Issue Paper No. 25.

#### **Disclosures**

16. The following disclosures shall be made in the notes to the financial statements of lessees:

- A general description of the lessee's leasing arrangements including, but not limited to, the following:

- (1) Rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.
- (2) The basis on which contingent rental payments are determined.
- (3) The existence and terms of renewal or purchase options and escalation clauses.
- (4) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

- Additionally, for leases having initial or remaining noncancelable lease terms in excess of one year:

- (1) Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

- (2) The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

- For sale-leaseback transactions:

- (1) A description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement.
- (2) For those accounted for as deposits, (a) the obligation for future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years and (b) the total of minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding years.

When leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the following information with respect to leases shall be disclosed in the financial statements:

- For operating leases:

- (1) The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property according to nature or function, and the amount of accumulated depreciation in total as of the date of the latest balance sheet presented;
- (2) Minimum future rentals on noncancelable leases as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding years;
- (3) Total contingent rentals included in income for each period for which an income statement is presented; and
- (4) A general description of the lessor's leasing arrangements.

- For leveraged leases:

- (1) a description of the terms including the pretax income from the leveraged leases shall be disclosed in the notes to the financial statements. For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment).
- (2) In the notes to the financial statements, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period.
- (3) When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases shall be disclosed in the notes to the financial statements.

## DISCUSSION

17. This issue paper provides more comprehensive guidance on accounting for leases than exists in the current statutory accounting literature. Nevertheless, the principles established are generally consistent with current statutory accounting principles.

18. This issue paper rejects FAS 13, as amended and interpreted, except for certain of the guidance on operating leases, sale-leaseback transactions and leveraged leases (i.e., paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 38.b., 39.c. and, 42-47). A complete list of all FASB Statements, Interpretations and Technical Bulletins adopted and rejected by this issue paper is included in the Relevant GAAP Literature section of this paper. FAS 13 was rejected because this issue paper provides that all leases except for leveraged leases, are accounted for as operating leases, whereas the essence of FAS 13 is to classify and account for leases as either capital or operating.

19. The statutory accounting principles differ from GAAP as follows:

- All leases except for leveraged leases for lessors are accounted for as operating leases. Under GAAP, leases are treated as operating or capital by lessees and as operating, sales-type, direct financing or leveraged leases by lessors.
- No distinction is made between current and long term classifications on the balance sheet.
- Sale-leaseback transactions involving related parties and nonadmitted assets are accounted for by the seller-lessee as deposits.

20. In rejecting the FAS 13 guidance on capital and financing leases for all leases other than leveraged leases, the financial statement impact of classification and accounting for the different types of leases under GAAP was considered and is explained and described below for both lessees and lessors:

#### Lessee

Capital lease - A capital lease is reflected on the lessee's balance sheet as both an asset and a corresponding liability. A capital lease generally produces a declining income statement charge over the term of the lease, represented by the sum of amortization of the capitalized asset, usually straight-line, and a declining interest expense element on the lease obligation balance. The effect is similar to that which would result if the lessee borrowed money and purchased the asset outright instead of leasing it.

Operating lease - An operating lease does not result in an asset or liability being reflected on the lessee's balance sheet. An operating lease normally results in a level income statement charge over the term of the lease reflecting the rent payments required by the lease agreement.

#### Lessor

Direct financing lease - A direct financing lease is treated as in effect a loan, producing declining revenue similar to interest over the term of the lease. Under the accelerated pattern of revenue recognition provided by a direct financing lease, revenue declines relative to the lessor's declining investment and thus matches the pattern of the lessor's interest carrying costs, either explicit or implicit. The balance sheet effect of the accounting for a direct financing lease is that the lessor's asset is effectively converted from a property classification to a receivable (net investment in the lease).

Sales-type lease - In addition to the effects of the direct financing lease described above, in a sales-type lease the manufacturer or dealer records a sale and the related cost of sales and gross profit at the beginning of the lease. In the balance sheet the treatment converts leased property carried at manufacturing or wholesale cost to a receivable equal to the normal selling price (i.e., the price the asset would sell for in an arms-length transaction).

Leveraged Leases - Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially "leveraged" in the transaction), property,

plant or equipment with the intentions to lease the asset(s) to the lessee. Except for the exclusion of leveraged leases from the definition of a direct financing leases, it otherwise meets the definition of a direct financing lease. A leveraged lease involves at least three parties: the lessee, a long-term creditor, and a lessor. The long-term creditor provides financing, which is a significant percentage of the cost of the property, to the lessor which is nonrecourse as to the general credit of the lessor. The lessor's investment in the property declines after the original investment has been made, often turns negative, and then increases during later years of the lease before it finally is realized. The lessor records the investment in a leveraged lease net of the nonrecourse debt. Income is recognized only in periods in which the net investment is positive.

Operating lease - An operating lease generally produces a level income effect over the term of the lease, represented by the excess of the level rent payments called for by the lease agreement over straight-line depreciation of the leased asset. (This level income from the lease would compare to a generally declining pattern of either explicit or implicit interest carrying costs.) Depreciable life would extend beyond the initial lease term. The rental income and depreciation are shown broad in the income statement as revenue and expense, respectively. For balance sheet purposes, the leased asset is classified with or near property, plant and equipment.

21. Since (a) statutory accounting principles provide for offsetting of obligations against real estate assets, (b) certain assets would be considered nonadmitted assets if capitalized, (c) most leases are considered operating leases under GAAP and (d) leasing is not a significant part of insurance companies business the objectives of statutory accounting would not be appreciably enhanced by adopting the GAAP guidance.

22. In addition, the statutory accounting principles established in this issue paper provide for the deferral of any gains on sales of property with a leaseback, except if certain strict criteria are met. Such accounting meets the conservatism objective in the Statement of Concepts. Furthermore, the statutory accounting principles established for sale-leaseback transactions of nonadmitted assets with related parties meet the conservatism objective by eliminating the possibility of surplus enhancement through sale-leaseback transactions involving nonadmitted assets.

#### **Drafting Notes/Comments**

- Accounting for real estate, including sales of real estate, is addressed in *Issue Paper No. 40—Real Estate Investments*.
- Accounting for related party transactions is addressed in *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.
- *Issue Paper No. 34—Investment Income Due and Accrued* allows investment income not yet due to be considered an admitted asset. Under this issue paper rental income may be recognized before it is due.

### **RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

#### **Statutory Accounting**

23. Chapter 8 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses accounting for leases as follows:

##### **Investments in Real Estate, Equipment and Other Assets Involving Leases**

The statutory method of accounting for lease and sale leaseback arrangements is governed largely by the form of the agreement to which the insurance company is party. Life insurance companies are encouraged to account for lease purchase transactions with the same objectives in mind as in accounting for all transactions, conservatism and policyholder protection. Financial Accounting Standards Board Statements 13, 28, and 66 are commonly used as guidelines where not in conflict with statutory accounting principles.

24. The accounting treatment as stated in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies is similar to the treatment stated in the preceding paragraph.

25. In the August 5, 1987 meeting of the Emerging Accounting Issues Working Group, a consensus was reached as to the accounting for free rent. The minutes read as follows:

#### Accounting for Free Rent

The recent soft real estate market has given rise to the unusual situation of new tenants receiving “free rent” during initial periods of tenancy. An insurer requested direction as to the appropriate statutory accounting treatment during the term of the lease.

Two alternatives were considered by the working group:

1. A “cash basis” method reflecting no payments during the “free rent” period and then accounting for the monthly rentals as payments are made.
2. A method based on GAAP treatment which would require the spreading of the actual rent to be paid over the full lease period. The “free rent” period would reflect monthly rent expense on an accrual basis. The accrued rent liability would increase during the “free rent” period and be reduced monthly with the cash payment of rent after the initial period.

The working group concluded that the second method was preferable.

26. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of a sale and leaseback of home office buildings in their May 7, 1986 meeting. The minutes are as follows:

#### Sale and Leaseback of Home Office Buildings

The third area of discussion was the sale and leaseback of home office buildings where notes are taken back as part of the purchase price and the result is an increase to the insurers surplus through recognition of gain on the sale.

The issues discussed and the consensus reached were:

1. Should FASB 66 be applicable for statutory purposes?
2. Is there a need for special statutory accounting direction or should each situation be treated individually?

Present statutory accounting probably permits recognition of the gain. The group believes, however, that FASB 66 should be used for guidance by regulators, if not contrary to law, and, at a commissioner's discretion.

27. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of a sale and leaseback of furniture and equipment in their September 11, 1989, meeting. The minutes are as follows:

#### Accounting for Sale and Leaseback of Furniture and Equipment

Mr. Robert Solitro, Director of Examinations for the State of New Hampshire Insurance Department, had requested that this item be placed on the agenda of the working group. His request included an issue summary (Attachment A).

In the situation described, an insurance company would enter into a sale and lease-back agreement with a third party, non-affiliate, in which nonadmitted furniture is sold and then leased-back. As described, the terms of the agreement would provide that future payments to be made



by the insurance company would be equal to or greater than the proceeds to be received from the original sale.

The issue identified and addressed by the working group at this meeting was as follows:

Should the transaction be accounted for as an operating lease or a capital lease?

The working group reached the consensus that for sale and leaseback transactions involving furniture and non-EDP equipment guidance should be obtained from FASB No. 13 and related amendments. In a case where it is determined that the transaction results in a capital lease, no surplus enhancement should be recorded.

28. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of capital gains and increased real estate valuation through sale-leaseback and repurchase transactions in their December 4, 1989, meeting. The minutes are as follows:

Capital Gains and Increased Real Estate Valuation Through Sale-Leaseback and Repurchase Transactions

This topic was raised by Hyrum Gentner, Chief Insurance Examiner of the Utah Insurance Department and John Kay, Senior Examiner in that department (Attachment G). The situation described involved the sale and lease-back of an insurers real estate with the insurer accepting a note for most of the proceeds of the sale. The lease-back was for 12 months with an option for an additional 19 years. The insurer paid for an option to repurchase the property. A significant gain was realized on the sale. The insurer repurchased the property and used the repurchase cost plus the cost of the repurchase option to determine the book value of the real estate. The result was an increased valuation, slightly less than the realized capital gain on the sale.

Mr. Gentner and Mr. Kay had also indicated that the Utah Department had been faced with three alternatives: (1) to recognize the gain and increased asset valuation, (2) to not recognize the gain and increased asset valuation, and (3) to recognize both and make full disclosure including a comment expressing the Insurance Department concern regarding the nature of the transactions. In connection with the last option, regulations would then be implemented requiring prior written departmental approval for such transactions and specifying the Commissioners authority to establish investment valuation reserves.

After a general discussion of the subject, Norris Clark, chair of the working group was authorized to respond to the Utah Insurance Department stating that the issue had been discussed at the January 22, 1986 (86-1) and May 7, 1986 (86-3) meetings of the working group and that the transactions discussed by Mr. Gentner and Mr. Kay appeared to be of the kind in which no gain should be recognized.

**Generally Accepted Accounting Principles**

29. Accounting for leases is governed by *FASB Statement No. 13, Accounting for Leases*, as amended and interpreted by incorporating FASB Statements, Interpretations, and Technical Bulletins. Some key paragraphs of the FASB Current Text, Section L10, Leases, follow (note that the Current Text is an integration of currently effective accounting and reporting standards and that the authority of the Current Text is derived from the underlying pronouncements, which remain in force):

.102 For purposes of applying the accounting and reporting standards [herein], leases are classified as follows:

- a. Classifications from the standpoint of the lessee:
  - (1) Capital leases. Leases that meet one or more of the criteria in paragraph .103.
  - (2) Operating leases. All other leases.
- b. Classifications from the standpoint of the lessor: [FAS 13, ¶6]

- (1) Sales-type leases. Leases that give rise to manufacturer's or dealer's profit (or loss) to the lessor (that is, the fair value of the leased property at the inception of the lease is greater or less than its cost or carrying amount, if different) and that meet one or more of the criteria in paragraph .103 and both of the criteria in paragraph .104, except as indicated in the following sentence. A lease involving real estate shall be classified as a sales-type lease only if it meets the criterion in paragraph .103(a), in which case the criteria in paragraph .104 do not apply. [FAS 98, ¶22c] Normally, sales-type leases will arise when manufacturers or dealers use leasing as a means of marketing their products. Leases involving lessors that are primarily engaged in financing operations normally will not be sales-type leases if they qualify under paragraphs .103 and .104, but will most often be direct financing leases, described in paragraph .102(b)(2) below. However, a lessor need not be a dealer to realize dealer's profit (or loss) on a transaction, for example, if a lessor, not a dealer, leases an asset that at the inception of the lease has a fair value that is greater or less than its cost or carrying amount, if different, such a transaction is a sales-type lease, assuming the criteria referred to are met. [FAS13, ¶6] Leases of a manufacturing company's equipment sold to a leasing subsidiary that are accounted for as direct financing leases on the subsidiary's financial statements normally would be sales-type capital leases in the consolidated financial statements. [FAS94, ¶52] A renewal or extension of an existing sales-type or direct financing lease that otherwise qualifies as a sales-type lease shall be classified as a direct financing lease unless the renewal or extension occurs at or near the end of the original term 3 specified in the existing lease, in which case it shall be classified as a sales-type lease (refer to paragraph .113(f)). [FAS27, ¶6]
- (2) Direct financing leases. Leases other than leveraged leases that do not give rise to manufacturer's or dealer's profit (or loss) to the lessor but that meet one or more of the criteria in paragraph .103 and both of the criteria in paragraph .104. In such leases, the cost or carrying amount, if different, and fair value of the leased property are the same at the inception of the lease. [FAS13, ¶6] An exception arises when an existing sales-type or direct financing lease is renewed or extended during the term of the existing lease. [FAS27, ¶7] In such cases, the fact that the carrying amount of the property at the end of the original lease term is different from its fair value at that date shall not preclude the classification of the renewal or extension as a direct financing lease (refer to paragraph .113(f)).
- (3) Leveraged leases. Leases that meet the criteria of paragraph .144. [FAS13, ¶6]
- (4) Operating leases. All other leases, including leases that involve real estate and give rise to manufacturer's or dealer's profit (or loss) to the lessor but do not meet the criterion in paragraph .103(a). [FAS98, ¶22d] Criteria for Classifying Leases (Other Than Leveraged Leases)

.103 The criteria for classifying leases set forth in this paragraph and in paragraph .104 derive from the concept [FAS 13, paragraph 7] that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase. [FAS 13, paragraph 60] If at its inception a lease meets one or more of the following four criteria, the lease shall be classified as a capital lease by the lessee. Otherwise, it shall be classified as an operating lease. (Refer to paragraph .150 and Exhibit 150C for an illustration of the application of these criteria.)

- a. The lease transfers ownership of the property to the lessee by the end of the lease term.<sup>4a</sup>
- b. The lease contains a bargain purchase option.
- c. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25

- percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.
- d. The present value<sup>5</sup> at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs, to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him.<sup>6</sup> However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease. A lessee shall compute the present value of the minimum lease payments using its incremental borrowing rate unless (1) it is practicable for him to learn the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate. [FAS 13, paragraph 7]

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<sup>4a</sup> This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title. [FAS 98, paragraph 22.e.]

<sup>5</sup> Refer to paragraphs .509 through .511 for supplemental guidance on the interest rate to be used in calculating the present value of minimum lease payments.

<sup>6</sup> The 90-percent test is stated as a lower limit rather than as a guideline. [FIN 19, paragraph 4]

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.104 From the standpoint of the lessor, a lease involving real estate shall be classified as a sales-type lease only if it meets the criterion in paragraph .103(a) as appropriate under paragraph .102(b)(1). Otherwise, if the lease at inception meets any one of the four criteria in paragraph .103 and in addition meets both of the following criteria, it shall be classified as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph .102(b). If the lease does not meet any of the criteria of paragraph .103 or both of the following criteria, the lease shall be classified as an operating lease.

- a. Collectibility of the minimum lease payments is reasonably predictable. A lessor shall not be precluded from classifying a lease as a sales-type lease, a direct financing lease, or a leveraged lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables. [FAS98, ¶22f]
- b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.<sup>7</sup> Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs to be paid by the lessor (refer to paragraphs .113(a) and .114(a)) shall not by itself constitute an important uncertainty as referred to herein. [FAS13, ¶8]

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<sup>7</sup> If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at the inception of the lease, the classification criteria of paragraph .104(b) shall be applied at the date that construction of the property is completed or the property is acquired by the lessor. [FAS23, ¶ 7]

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.105 If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a

different classification of the lease under the criteria in paragraphs .103 and .104 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs .103 and .104 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs .108 and .113(e), any action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the provisions of paragraphs .102 through .104. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, shall not give rise to a new classification of a lease for accounting purposes. [FAS13, ¶9]

## Accounting and Reporting by Lessees

### Operating Leases

.111 Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis,<sup>13a</sup> rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used. [FAS 13, paragraph 15]

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<sup>13a</sup> Refer to paragraphs .525 through .527F for supplemental guidance on accounting for operating leases with scheduled rent increases and lease incentives.

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.112 The following information with respect to leases shall be disclosed in the lessees financial statements or the footnotes thereto. (Refer to paragraphs .151 and .152 for illustrations.)

- b. For operating leases having initial or remaining noncancelable lease terms in excess of one year:
  - (1) Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.
  - (2) The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.
- c. For all operating leases, rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.
- d. A general description of the lessees leasing arrangements including, but not limited to, the following:
  - (1) The basis on which contingent rental payments are determined.
  - (2) The existence and terms of renewal or purchase options and escalation clauses.
  - (3) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing. [FAS 13, paragraph 16]

## Sales-Type Leases

.113 Sales-type leases shall be accounted for by the lessor as follows:

- a. The minimum lease payments (net of amounts, if any, included therein with respect to executory costs to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value accruing to the benefit of the lessor shall be recorded as the gross investment in the lease.<sup>13b</sup> [FAS13, ¶17] The estimated residual value used to compute the unguaranteed residual value accruing to the benefit of the lessor shall not exceed the amount estimated at the inception of the lease.<sup>14</sup> [FAS23, ¶9] However, if the sales-type lease involves real estate, the lessor shall account for the transaction under the provisions of Section R10, "Real Estate," in the same manner as a seller of the same property. [FAS98, ¶22g]

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<sup>13b</sup> Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payment.

<sup>14</sup> If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of the paragraph. [FAS23, ¶9]

- b. The difference between the gross investment in the lease in (a) above and the sum of the present values of the two components of the gross investment shall be recorded as unearned income. The discount rate to be used in determining the present values shall be the interest rate implicit in the lease. The net investment in the lease shall consist of the gross investment less the unearned income. The unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.<sup>15</sup> However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. [FAS13, ¶17] Contingent rentals shall be included in the determination of income as accruable. [FAS29, ¶13] [(Refer to paragraph .165 for an illustration involving contingent rentals.)]

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<sup>15</sup> This is the interest method described in Section 169, paragraph .108 and footnote 4. [FAS13, ¶12, fn 11]

- c. The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs, less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.
- d. The estimated residual value shall be reviewed at least annually.<sup>16</sup> If the review results in a lower estimate than had been previously established, a determination must be made as to whether the decline in estimated residual value is other than temporary. If the decline in estimated residual value is judged to be other than temporary, the accounting for the transaction shall be revised using the changed estimate. The resulting reduction in the net investment shall be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value shall not be made.

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<sup>16</sup> Paragraphs .514 through .517 discuss upward adjustment of guaranteed residential values.

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- e. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,<sup>17</sup> following the method of amortization described in (b) above will result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension of the lease term renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value shall be adjusted for the changes resulting from the revised agreement (subject to the limitation on the residual value imposed by subparagraph (d) above) and the net adjustment shall be charged or credited to unearned income. [FAS13, ¶17]

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<sup>17</sup> Residual guarantees and termination penalties that serve to extend the lease term are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph. [FAS13, ¶17 fn 17]

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- f. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (refer to paragraph .110), a change in the provisions of a lease, a renewal or extension of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows: [FAS22, 15]
- (1) If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement under the provisions of paragraph .105 or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments receivable and the estimated residual value, if affected, shall be adjusted to reflect the change (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment shall be charged or credited to unearned income. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the remaining net investment shall be removed from the accounts, the leased asset shall be recorded as an asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. The new lease shall thereafter be accounted for as any other operating lease.
  - (2) Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension of an existing lease shall be accounted for as follows:
    - (a) If the renewal or extension is classified as a direct financing lease, it shall be accounted for as described in subparagraph (f)(1) above.
    - (b) If the renewal or extension is classified as an operating lease, the existing lease shall continue to be accounted for as a sales-type lease to the end of its original term, and the renewal or extension shall be accounted for as any other operating lease. [FAS13, ¶17]

- (c) If a renewal or extension that occurs at or near the end of the term<sup>18</sup> of the existing lease is classified as a sales-type lease, the renewal or extension shall be accounted for as a sales-type lease. [FAS27, ¶8]

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<sup>18</sup> A renewal or extension that occurs in the last few months of an existing lease is considered to have occurred at or near the end of the existing lease term. [FAS27, ¶8]

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- (3) A termination of the lease shall be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. [FAS13, ¶17]
- g. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding,<sup>19</sup> in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a direct financing lease by the lessor, the change shall be accounted for as follows:<sup>20</sup>
- (1) If a change in the provisions of a lease results from a refunding of tax-exempt debt, including an advance refunding that is accounted for as an early extinguishment of debt, the lessor shall adjust the balance of the minimum lease payments receivable and the estimated residual value, if affected (that is, the gross investment in the lease), in accordance with the requirements of paragraphs .114(c) and .113(f)(1). The adjustment of unearned income shall be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences shall be recognized as a gain or loss in the current period. [Paragraphs .162 and .163 illustrate the accounting prescribed by this paragraph.]
- (2) If a change in the provisions of the lease results from an advance refunding that is not accounted for as an early extinguishment of debt at the date of the advance refunding, the lessor shall systematically recognize, as revenue, any reimbursements to be received from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the period from the date of the advance refunding to the call date of debt to be refunded. [FAS22, ¶12]

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<sup>19</sup> An advance refunding involves the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates. [FAS22, ¶1, fn1] Section D14, "Debt: Extinguishments," provides criteria for determining whether the advance refunding should be recognized as an extinguishment of the existing debt at the date of the advance refunding. FAS76, ¶10]

<sup>20</sup> This paragraph prescribes the accounting for a direct financing lease by governmental units that classify and account for leases of that kind [FAS22, ¶12, fn4]

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## Accounting and Reporting by Lessors

## Operating Leases

.115. Operating leases shall be accounted for by the lessor as follows:

- a. The leased property shall be included with or near property, plant, and equipment in the balance sheet. The property shall be depreciated following the lessor's normal depreciation policy, and in the balance sheet the accumulated depreciation shall be deducted from the investment in the leased property.
- b. Rent shall be reported as income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis,<sup>24a</sup> the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used.

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<sup>24a</sup> Refer to paragraphs .525 through .527F for supplemental guidance on accounting for operating leases with scheduled rent increases and lease incentives.

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- c. Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence. [FAS 13, paragraph 19]
- d. If, at the inception of the lease, the fair value of the property in an operating lease involving real estate that would have been classified as a sales-type lease except that it did not meet the criterion in paragraph .103(a) is less than its cost or carrying amount, if different, then a loss equal to that difference shall be recognized at the inception of the lease. [FAS 98, paragraph 22.j.]

## Sale-Leaseback Transactions

.128 Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the seller-lessee in accordance with the provisions of paragraph .129 [except that a sale-leaseback involving real estate, property improvements, or integral equipment<sup>27a</sup> shall be accounted for in accordance with the provisions of paragraphs .130A through .130M]. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the [buyer-lessor] in accordance with the provisions of paragraph .130. [FAS28, paragraph 2] [See paragraphs .544 through .545 for supplemental guidance in accounting for sale-leaseback transactions when nonrecourse debt is obtained using the lease rentals or lease rentals and the leased asset as collateral and the nonrecourse debt is sold with the asset to a third party investor (a wrap lease transaction).]

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<sup>27a</sup> The terms *property improvements* and *integral equipment* are discussed in paragraph .130A and footnote 32a.

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.129 If the lease meets one of the criteria for treatment as a capital lease (refer to paragraph .103), the seller-lessee shall account for the lease as a capital lease; otherwise, as an operating lease. Any profit or loss on the sale<sup>28</sup> shall be deferred and amortized in proportion to the amortization of the lease asset<sup>29</sup>, if a capital lease, or in proportion to the related gross rental charged to expense over the lease term, if an operating lease, unless:

- a. The seller-lessee relinquishes the right to substantially all of the remaining use of the property sold (retaining only a minor portion of such use),<sup>30</sup> in which case the sale and the leaseback shall be accounted for as separate transactions based on their respective terms. However, if the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease, an appropriate amount shall be deferred or accrued, by adjusting the profit or loss on the sale, and amortized as specified in the introduction of this paragraph to adjust those rentals to a reasonable amount.

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<sup>28</sup> *Profit or loss on the sale* is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to Section R10, the profit on the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with that section. [FAS28, ¶3]

<sup>29</sup> If the leased asset is land only, the amortization shall be on a straight-line basis over the lease term. [FAS13, ¶33, fn23]

<sup>30</sup> *Substantially all* and *minor* are used here in the context of the concepts underlying the classification criteria of this section. In that context, a test based on the 90-percent recovery criterion of paragraph .103(d) could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the [buyer-lessor] the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use. [FAS28, ¶3a]

- b. The seller-lessee retains more than a minor part but less than substantially all<sup>31</sup> of the use of the property through the leaseback and realizes a profit on the sale<sup>32</sup> in excess of (1) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or (2) the recorded amount of the leased asset, if the leaseback is classified as a capital lease. In that case, the profit on the sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, shall be recognized at the date of the sale. For purposes of applying this provision, the present value of the minimum lease payments for an operating lease shall be computed using the interest rate that would be used to apply the 90 percent recovery criterion of paragraph .103(d).
- c. If the lease meets the criteria in paragraphs .103 and .104, the [buyer-lessor] shall record the transaction as a purchase and a direct financing lease; otherwise, the [buyer-lessor] shall record the transaction as a purchase and an operating lease. [FAS 13, paragraph 34]

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<sup>31</sup> *Substantially all* is used here in the context of the concepts underlying the classification criteria of this section. In that context, if a leaseback of *the entire property sold* meets the criteria of this section for classification as a capital lease, the seller-lessee would be presumed to have retained substantially all of the remaining use of the property sold. [FAS28, ¶3b]

<sup>32</sup> *Profit or loss on the sale* is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to Section R10, the profit on the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with that section. [FAS28, ¶3]

## Sale-Leaseback Transactions Involving Real Estate

.130A Paragraphs .130A through .130M [present] standards of financial accounting and reporting by a seller-lessee for sale-leaseback transactions involving real estate, including real estate with equipment, such as manufacturing facilities, power plants, and office buildings with furniture and fixtures. A sale-leaseback transaction involving real estate with equipment includes any sale-leaseback transaction in which the equipment and the real estate are sold and leased back as a package, irrespective of the relative value of the equipment and the real estate. Those paragraphs also address sale-leaseback transactions in which the seller-lessee sells property improvements or integral equipment<sup>32a</sup> to a buyer-lessor and leases them back while retaining the underlying land.<sup>32b</sup>

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<sup>32a</sup> The terms *property improvements* or *integral equipment* as used in paragraphs .130A through .130M of this section refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery. [FAS98, ¶6, fn2]

<sup>32b</sup> Paragraphs .141 and .142 of Section R10 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph .141 of Section R10 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraphs .130A through .130M of this section are not intended to modify paragraph .141 of Section R10; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph .141 of Section R10. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph .142 of Section R10. [FAS98, ¶6, fn3]

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## Sale-Leaseback Accounting

.130B Sale-leaseback accounting is a method of accounting for a sale-leaseback transaction in which the seller-lessee records the sale, removes all property and related liabilities from its balance sheet, recognizes gain or loss from the sale in accordance with [paragraphs .129 and .130A through .130M] and Section R10, and classifies the leaseback in accordance with this section. [FAS98, paragraph 70]

### Criteria for Sale-Leaseback Accounting

.130C Sale-leaseback accounting shall be used by a seller-lessee only if a sale-leaseback transaction includes all of the following:

- a. A normal leaseback as described in paragraph .130D
- b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (refer to paragraphs .111 through .119 of Section R10)
- c. Payment terms and provisions that transfer *all* of the other risks and rewards of ownership as demonstrated by the absence of *any* other continuing involvement by the seller-lessee described in paragraphs .130G through .130I of this section and paragraphs .128 through .142 and .144 through .146 of Section R10. [FAS98, paragraph 7]

.130D A *normal leaseback* is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee,<sup>32c</sup> and excludes other continuing involvement provisions or conditions described in paragraphs .130G through .130I of this section. The phrase *active use of the property by the seller-lessee* refers to the use of the property during the lease term in the seller-lessee's trade or business, provided that subleasing of the leased back property is minor.<sup>32d</sup> If the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold, the leased back property under sublease is considered minor. Active use of the property may involve

the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, housekeeping, inventory control, entertainment, bookkeeping, and food services. Thus, the use of property by a seller-lessee engaged in the hotel or bonded warehouse business or the operation of a golf course or a parking lot, for example, is considered active use. [FAS98, paragraph 8]

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<sup>32c</sup> Paragraphs .130A through .130M distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. The latter type of contingent rental is addressed in paragraph .130H(e) of this section. [FAS98, ¶8, fn4]

<sup>32d</sup> The term] *minor* is used here in the context of the definition in footnote 30 to paragraph .129. [FAS98, ¶8, fn6]

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### Terms of the Sale-Leaseback Transaction

.130E Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges shall be considered in evaluating the continuing involvement provisions in paragraphs .130G through .130I of this section. Those terms or conditions include, but are not limited to, the sales price, the interest rate, and other terms of any loan from the seller-lessee to the buyer-lessor. The fair value of the property used in making that evaluation shall be based on objective evidence, for example, an independent third-party appraisal or recent sales of comparable property. [FAS98, ¶9]

### Continuing Involvement

.130F A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback shall be accounted for by the deposit method or as a financing, whichever is appropriate under Section R10. The provisions or conditions described in paragraphs .130G through .130I of this section are examples of continuing involvement for the purpose of applying paragraphs .130A through .130M. [FAS98, ¶10]

.130G Paragraphs .128 through .142 and .144 through .146 of Section R10 describe forms of continuing involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Two examples of continuing involvement specified in those paragraphs that are frequently found in sale-leaseback transactions are provisions or conditions in which:

- a. The seller-lessee has an obligation or an option<sup>32e</sup> to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.
- b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time. [FAS98, ¶11]

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<sup>32e</sup> A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase. [FAS98, ¶11, fn7]

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.130H Other provisions or conditions that are guarantees and that do not transfer all of the risks of ownership shall constitute continuing involvement for the purpose of applying paragraphs .130A through .130M to sale-leaseback transactions and include, but are not limited to, the following:

- a. The seller-lessee is required to pay the buyer-lessor at the end of the lease terms for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.
- b. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.
- c. The seller-lessee is not relieved of the obligation under any existing debt related to the property.
- d. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.
- e. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.<sup>32f</sup> [FAS98, ¶12]

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<sup>32f</sup> Paragraphs .130A through .130M distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. [FAS98, ¶8, fn4]

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.130I The following provisions or conditions also shall be considered examples of continuing involvement for the purpose of applying paragraphs .130A through .130M to sale-leaseback transactions:

- a. The seller-lessee enters into a sale-leaseback transaction involving property improvements or integral equipment<sup>32g</sup> without leasing the underlying land to the buyer-lessor.<sup>32h</sup>
- b. The buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property.
- c. Any other provision or circumstance that allows the seller-lessee to participate in any future profits of the buyer-lessor or the appreciation of the leased property, for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessor. [FAS98, ¶13]

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<sup>32g</sup> The terms *property improvements* or *integral equipment* as used in paragraphs .130A through .130M refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery. [FAS98, ¶6, fn2]

<sup>32h</sup> Paragraphs .141 and .142 of Section R10 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph .141 of Section R10 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraph .130A through .130M of this section are not intended to modify paragraph .141 of Section R10; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph .141 of Section R10. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph .142 of Section R10. [FAS98, ¶6, fn3]

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### Financial Statement Presentation and Disclosure

.130K In addition to the [other] disclosure requirements of this section and Section R10, the financial statements of a seller-lessee shall include a description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement. [FAS98, ¶17]

.130L The financial statements of a seller-lessee that has accounted for a sale-leaseback transaction by the deposit method or as a financing according to the provisions of this section and Section R10 also shall disclose:

- a. The obligation for future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years.
- b. The total of minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding fiscal years. [FAS98, ¶18]

#### Accounting for and Reporting for Leveraged Leases

.143 From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as nonleveraged leases. The balance of this section deals with leveraged leases from the standpoint of the lessor. [FAS13, paragraph 41]

.144 For the purposes of this section, a leveraged lease is defined as one having all the following characteristics:

- a. Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph .102(b)(2), it otherwise meets that definition. Leases that meet the definition of sales-type leases set forth in paragraph .102 (b)(1) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph .113.
- b. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called an equity participant).
- c. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of financing is sufficient to provide the lessor with substantial *leverage* in the transaction.
- d. The lessor's net investment, as defined in paragraph .145, declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

A lease meeting the preceding definition shall be accounted for by the lessor using the method prescribed in paragraphs .145 through .149<sup>36a</sup>. An exception arises if the investment tax credit is accounted for other than stated in paragraphs .145 and .146,<sup>37</sup> in which case the lease shall be classified as a direct financing lease and accounted for in accordance with paragraph .114. A lease not meeting the definition of a leveraged lease shall be accounted for in accordance with its classification under paragraph .102(b). [FAS 13, ¶42]

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<sup>36a</sup> Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payments.]

<sup>37</sup> It is recognized that the investment tax credit may be accounted for other than as prescribed here, as provided by Congress in the Revenue Act of 1971. [FAS13, ¶42, fn24]

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.145 The lessor shall record its investment in a leveraged lease net of the nonrecourse debt. [37a]. The net of the balances of the following accounts shall represent the initial and continuing investment in leveraged leases:

- a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt.
- b. A receivable for the amount of investment tax credit to be realized on the transaction.

- c. The estimated residual value of the lease asset. The estimated residual value shall not exceed the amount estimated at the inception of the lease except as provided in footnote 38<sup>38</sup> [FAS23, ¶10]
- d. Unearned and deferred income consisting of (1) the estimated pretax lease income (or loss), after deducting the initial direct costs, remaining to be allocated to income over the lease term and (2) the investment tax credit remaining to be allocated to income over the lease term.

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<sup>37a</sup> Footnote 502 further discusses nonrecourse debt collateralized by a lease receivable

<sup>38</sup> If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of this paragraph. [FAS23, ¶10]

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The investment in leveraged leases less deferred taxes arising from differences between the pretax accounting income and taxable income shall represent the lessor's net investment in leveraged leases for purposes of computing periodic net income from the lease as described in paragraph .146. [FAS13, ¶43]

.146 Given the original investment and using the projected cash receipts and disbursements over the term of the lease, the rate of return on the net investment in the years<sup>39</sup> in which it is positive shall be computed. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the net income to those years (refer to Exhibit 154C) and is distinct from the interest rate implicit in the lease. In each year whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The net income recognized shall be composed of three elements: two, pretax lease income (or loss) and investment tax credit, shall be allocated in proportionate amounts from the unearned and deferred income included in net investment, as described in paragraph .145; the third element is the tax effect of the pretax lease income (or loss) recognized, which shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes. The accounting prescribed in paragraph .145 and in this paragraph is illustrated in paragraph .154. [FAS13, ¶44]

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<sup>39</sup> The use of the term *years* is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods. [FAS13, ¶44, fn 25]

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.147 If the projected net cash receipts<sup>40</sup> over the term of the lease are less than the lessor's initial investment, the deficiency shall be recognized as a loss at the inception of the lease. Likewise, if at any time during the lease term the application of the method prescribed in paragraphs .145 and .146 would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in cases in which one of the important assumptions affecting net income is revised (refer to paragraph .148). [FAS13, ¶45]

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<sup>40</sup> For purposes of this paragraph, net cash shall be gross cash receipts less gross cash disbursements exclusive of the lessor's initial investment. [FAS13, ¶44, fn 26]

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.148 Any estimated residual value and all other important assumptions affecting estimated total net income from the lease shall be reviewed at lease annually.<sup>[41]</sup> If during the lease term the estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary or if the revision of another important assumption changes the estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph .146 and using the revised assumption. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. An upward adjustment of the estimated residual value shall not be made.<sup>41a</sup> The accounting prescribed in this paragraph is illustrated in paragraph .154. [FAS13, ¶146]

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<sup>41</sup> Refer to paragraphs .521 through .524 for supplemental guidance on the effect of a change in income tax rate on the accounting for leveraged leases.

<sup>41a</sup> Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payments.]

#### Accounting for Income Taxes

.148A Section I27, "Income Taxes," does not change (a) the pattern of recognition of after-tax income for leveraged leases as required by this section or (b) the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by paragraphs .140 through .142. Integration<sup>41b</sup> of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes under Section I27 is required when deferred tax credits related to leveraged leases are the only source (refer to paragraph .120 of Section I27) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined under this section differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the requirements of Section I27, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards. [FAS109, ¶256]

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- <sup>41b</sup> Integration is an issue when all of the following exist:
- a. The accounting for a leveraged lease requires recognition of deferred tax credits.
  - b. The requirements of Section 127 limit the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.
  - c. Unrecognized tax benefits could offset taxable amounts that result from future recovery of the net investment in the leveraged lease.

In those circumstances, integration shall be required. However, integration should not override any results that are unique to income tax accounting for leveraged leases, for example, the manner of recognizing the tax effect of an enacted change in tax rates. [FAS109, ¶126]

.148B Paragraph .141 requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination not be accounted for as a deferred tax credit. Section I27 does not change that requirement. Any tax effects included in unearned and deferred income as required by this section are not offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a business combination are accounted for in the same manner as described above for leveraged leases that were not

acquired in a purchase business combination. [FAS109, ¶257] [Exhibit 185A in Section I27 presents an example that integrates the] accounting for leveraged leases [as required by this section] and the accounting for income taxes required by Section I27. [FAS109, ¶258]

#### Disclosures

.149 For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment). In the income statement or the notes thereto, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period. When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases as set forth in paragraph .145 shall be disclosed in the footnotes to the financial statements. Paragraph .154 contains an illustration of the balance sheet, income statement and footnote presentation for a leveraged lease. [FAS13, ¶47]

.401 Bargain purchase option. A provision allowing the lessee, at his option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured. [FAS 13, paragraph 5.d.].

.402 Bargain renewal option. A provision allowing the lessee, at [the lessee's] option, to renew the lease for a rental<sup>401</sup> sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured. [FAS13, ¶5e]

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<sup>401</sup> *Fair Rental* in this context shall mean the expected rental for equivalent property under similar terms and conditions. [FAS13, ¶5, fn 2]

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.404 Contingent rentals. The increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based, except as provided in the following sentence. Any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or preconstruction period, as discussed in footnote 13, shall be excluded from contingent rentals. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable. [FAS29, ¶11]

.406 Estimated economic life of leased property. The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term. [FAS 13, paragraph 5.g.].

.409 Fair value of the leased property. The price for which the property could be sold in an arms-length transaction between unrelated parties. The following are examples of the determination of fair value:

- a. When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its normal selling price, reflecting any



volume or trade discounts that may be applicable. However, the determination of fair value shall be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price and, in some instances, less than the cost of the property.

- b. When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its cost, reflecting any volume or trade discounts that may be applicable. However, when there has been a significant lapse of time between the acquisition of the property by the lessor and the inception of the lease, the determination of fair value shall be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different, (refer to paragraph .102). [FAS 13, paragraph 5.c.]

.412 Interest rate implicit in the lease. The discount rate that, when applied to (a) the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and (b) the unguaranteed residual value accruing to the benefit of the lessor<sup>403</sup> causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by him. (This definition does not necessarily purport to include all factors that a lessor might recognize in determining his rate of return, for example, see paragraph .146.) [FAS 13, paragraph 5.k.]

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<sup>403</sup> If the lessor is not entitled to any excess of the amount realized on disposition of the property over a guaranteed amount, no unguaranteed residual value would accrue to the lessors benefit. [FAS 13, paragraph 5.k., footnote 8]

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.413 Lease. An agreement conveying the right to use property, plant, or equipment (land or depreciable assets or both) usually for a stated period of time. [FAS 13, paragraph 1].

.414 Lease term. The fixed noncancelable term of the lease plus (a) all periods, if any, covered by bargain renewal options (as defined paragraph .402), (b) all periods, if any, for which failure to renew the lease imposes a penalty (as defined in paragraph .418A) on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (c) all periods, if any, covered by ordinary renewal options<sup>405</sup> during which a guarantee by the lessee of the lessors debt directly or indirectly related to the leased property<sup>405a</sup> is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (d) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph .401) is exercisable, and (e) all periods, if any, representing renewals or extensions of the lease at the lessors option; however, in no case shall the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A lease that is cancelable (1) only upon the occurrence of some remote contingency, (2) only with the permission of the lessor, (3) only if the lessee enters into a new lease with the same lessor, or (4) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured shall be noncancelable for purposes of this definition.[FAS 98, paragraph 22.a.]

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<sup>405</sup> Paragraphs .501 through .505 address fiscal funding clauses in lease agreements.

<sup>405a</sup> The phrase indirectly related to the leased property is used in this paragraph to describe provisions or conditions that in substance are guarantees of the lessors debt or loans to the lessor by the lessee that are related to the leased property but are structured in such a manner that they do not represent a direct guarantee or loan. Examples include a party related to the lessee guaranteeing the lessors debt on behalf of the lessee, or the lessee financing the lessors purchase of the leased asset using collateral other than the leased property. [FAS 98, paragraph 22.a.]

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.415 Lessees incremental borrowing rate. The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.<sup>406</sup>

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<sup>406</sup> Paragraphs .509 through .511 further discuss the interest rate used in calculating the present value of the minimum lease payments.

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.417 Minimum lease payments.

(a) From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property. [FAS 13, paragraph 5.j.], (Contingent rentals, as defined in paragraph .404, shall be excluded from minimum lease payments.) [FAS 29, paragraph 10] However, a guarantee by the lessee of the lessors debt and the lessees obligation to pay (apart from the rental payments) executory costs in connection with the leased property shall be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term (as defined in paragraph .413) and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include the following:

- (1) The minimum rental payments called for by the lease over the lease term.
- (2) Any guarantee by the lessee or any party related to the lessee of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property.<sup>407</sup> When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee. When the lessee agrees to make up any deficiency<sup>408</sup> below a stated amount in the lessors realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount,<sup>409</sup> rather than an estimate of the deficiency to be made up.

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<sup>407</sup> A guarantee of the residual value obtained by the lessee from an unrelated third party for the benefit of the lessor shall not be used to reduce the amount of the lessees minimum lease payments except to the extent that the lessor explicitly releases the lessee from obligation, including secondary obligation if the guarantor defaults, to make up a residual value deficiency. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessees minimum lease payments.

<sup>408</sup> A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals in that the amount is not determinable at the inception of the lease. Such a provision does not constitute a lessee guarantee of the residual value.

<sup>409</sup> If a lease limits the amount of the lessees obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessees guarantee to be included in minimum lease payments shall be limited to the specified maximum deficiency the lessee can be required to make up. The *stated amount* is the specified maximum deficiency that the lessee is obligated to make up. If that maximum deficiency clearly exceeds any reasonable estimate of a deficiency that might be expected to arise in normal circumstances, the lessors risk associated with the portion of the residual in excess of the maximum may appear to be negligible. However, the fact remains that the lessor must look to the resale market or elsewhere rather than to the lessee to recover the unguaranteed portion of the stipulated residual value of the leased property. The lessee has not guaranteed full recovery of the residual value, and the parties should not base their accounting on the assumption that the lessee has guaranteed it.

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- (3) Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the lease property. In this connection, it should be noted that the definition of lease term (refer to paragraph .413) includes all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured. If the lease term has been extended because of that provision, the related penalty shall not be included in the minimum lease payments.
- (b) From the standpoint of the lessor: The payments described above plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee or the lessor,<sup>410</sup> provided the third party is financially capable of discharging the obligations that may arise from the guarantee. [FAS 13, paragraph 5.j.]

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<sup>410</sup> If the guarantor is related to the lessor, the residual value shall be considered as unguaranteed.

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.418A Penalty. Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider when determining if an economic detriment may be incurred include, but are not limited to, the uniqueness of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers, the existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property, adverse tax consequences, and the ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property. [FAS98, ¶22b]

.419 Related parties. A parent company and its subsidiaries, an owner company and its joint ventures (corporate or otherwise) and partnerships, and an investor (including a natural person) and its investees, provided that the parent company, owner enterprise, or investor has the ability to exercise significant influence over operating and financial policies of the related party, as significant influence is defined in section 182, paragraph 104. In addition to the examples of significant influence set forth in that paragraph, significant influence may be exercised through guarantees of indebtedness, extensions of credit, or through ownership of warrants, debt obligations, or other securities. If two or more enterprises are subject to the significant influence of a parent company, owner enterprise, investor (including a natural person), or common officers or directors, those enterprises shall be considered related parties with respect to each other. [FAS 13, paragraph 5.a.]

30. *FAS 66, Accounting for Sales of Real Estate*, defines the deposit method of accounting as follows:

#### Deposit Method

65. Under the deposit method, the seller does not recognize any profit, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer, and discloses that those items are subject to a sales contract. The seller continues to charge depreciation to expense as a period cost for the property for which deposits have been received. Cash received from the buyer, including the initial investment and subsequent collections of principal and interest, is reported as a deposit on the contract except that, for sales that are not retail land sales, portions of cash received that are designated by the contract as interest and are not subject to refund offset carrying charges (property taxes and interest on existing debt) on the property. Interest collected that is subject to

refund and is included in the deposit account before a sale is consummated is accounted for as part of the buyer's initial investment at the time the sale is consummated.[FAS66, ¶7]

66. When a contract is canceled without a refund, deposits forfeited are recognized as income. When deposits on retail land sales are ultimately recognized as sales, the interest portion is recognized as interest income.

67. The seller's balance sheet presents nonrecourse debt assumed by the buyer among the liabilities; the debt assumed is not offset against the related property. The seller reports the buyer's principal payments on mortgage debt assumed as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

31. *FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases*, provides the following guidance:

#### Question

1. Certain operating lease agreements specify scheduled rent increases over the lease term. Such scheduled rent increases may, for example, be designed to provide an inducement or "rent holiday" for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements, or to acknowledge the time value of money. For operating leases that include scheduled rent increases, is it ever appropriate for lessees or lessors to recognize rent expense or rental income on a basis other than the straight-line basis required by Statement 13?

#### Response

2. The effects of those scheduled rent increases, which are included in minimum lease payments under Statement 13, should be recognized by lessors and lessees on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money, anticipated inflation, or expected future revenues to allocate scheduled rent increases is inappropriate because these factors do not relate to the time pattern of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under Statement 13, as amended by Statement 29.

32. *FASB Technical Bulletin 88-1, Issues relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease, Lease Incentives in an Operating Lease, Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor, Money-Over-Money Lease Transactions, Wrap Lease Transactions*, provides the following guidance on operating leases:

#### TIME PATTERN OF THE PHYSICAL USE OF THE PROPERTY IN AN OPERATING LEASE

References: *FASB Statement No. 13, Accounting for Leases*, paragraph 15

*FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases*

#### Question 1

1. A lease agreement may include scheduled rent increases designed to accommodate the lessee's projected physical use of the property. For example, rents may escalate in contemplation of the lessee's physical use of the property even though the lessee takes possession of or controls the physical use of the property at the inception of the lease, or rents may escalate under a master lease agreement as the lessee adds additional equipment to the leased property or requires additional space or capacity (hereinafter referred to as additional leased property).

For operating leases that include those provisions, how should the rental payment obligation be recognized by the lessee and lessor in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3?

#### Response

2. Both the lessee and the lessor should recognize the lease payments under Statement 13 and Technical Bulletin 85-3 as follows:

- a. If rents escalate in contemplation of the lessee's physical use of the leased property, including equipment, but the lessee takes possession of or controls the physical use of the property at the beginning of the lease term, all rental payments, including the escalated rents, should be recognized as rental expense or rental revenue on a straight-line basis in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3 starting with the beginning of the lease term.
- b. If rents escalate under a master lease agreement because the lessee gains access to and control over additional leased property at the time of the escalation, the escalated rents should be considered rental expense or rental revenue attributable to the leased property and recognized in proportion to the additional leased property in the years that the lessee has control over the use of the additional leased property. The amount of rental expense or rental revenue attributed to the additional leased property should be proportionate to the relative fair value of the additional property, as determined at the inception of the lease, in the applicable time periods during which the lessee controls its use.

#### Background

3. This issue involves how to apply Technical Bulletin 85-3 to lease agreements that escalate rents in contemplation of the lessee's projected use of the property. The issue arises from paragraph 2 of Technical Bulletin 85-3, which states “. . . scheduled rent increases, which are included in minimum lease payments under Statement 13, should be recognized by lessors and lessees on a straight-line basis over the lease term UNLESS ANOTHER SYSTEMATIC AND RATIONAL ALLOCATION BASIS IS MORE REPRESENTATIVE OF THE TIME PATTERN IN WHICH THE LEASED PROPERTY IS PHYSICALLY EMPLOYED” (emphasis added).

4. This Technical Bulletin considers the right to control the use of the leased property as the equivalent of physical use. When the lessee controls the use of the leased property, recognition of rental expense or rental revenue should not be affected by the extent to which the lessee utilizes that property.

5. This Technical Bulletin makes a distinction between agreements that give the lessee the right to control the use of the leased property at the beginning of the lease term and those that do not. Escalated rents under agreements that give the lessee the right to control the use of the entire leased property at the beginning of the lease term should be included in the minimum lease payments and recognized on a straight-line basis over the lease term. When the agreement provides that the lessee gains control over additional leased property, rental expense or rental revenue should be recognized based on the relative fair value of the additional property leased and the period during which the lessee has the right to control the use of the additional property. This is the intent of Statement 13 and Technical Bulletin 85-3.

#### LEASE INCENTIVES IN AN OPERATING LEASE

References: *FASB Statement No. 13, Accounting for Leases*, paragraphs 15, 19, and 35-40

*FASB Technical Bulletin No. 79-15, Accounting for Loss on a Sublease Not Involving the Disposal of a Segment*

*FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases*

Question 2

6. An operating lease agreement with a new lessor may include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee's preexisting lease with a third party. For operating leases that include such incentives, should lessees or lessors ever recognize those incentives as rental expense or rental revenue other than on a straight-line basis in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3?

Response

7. Payments made to or on behalf of the lessee represent incentives that should be considered reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the term of the new lease. Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered an incentive by both the lessor and the lessee. Incentives should be recognized on a straight-line basis over the term of the new lease in accordance with paragraph 15 of Statement 13, Technical Bulletin 85-3, and paragraphs 1-5 above.

8. The lessee's immediate recognition of expenses or losses, such as moving expenses, losses on subleases, or the write-off of abandoned leasehold improvements, is not changed by this Technical Bulletin. Rather, this Technical Bulletin addresses the question of when to recognize the incentive related to the new lessor's assumption of that expense or loss. The new lessor and the lessee should independently estimate any loss attributable to the assumption of a preexisting lease with a third party. For example, the lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption, and the lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed leased property.

9. For example, in conjunction with an operating lease of property for eight years, the lessor assumes the lessee's preexisting lease with a third party that has four years remaining. Assume that the old lease payment is \$800 per year and the new lease payment is \$1,200 per year. Also assume that the lessor estimates the loss on the assumed lease of \$1,000 over its remaining term based on the ability to sublease the property for \$550 per year. The lessee estimates the incentive as \$960 based on a comparison of the preexisting lease rate to current rates for similar property. The accounting for that incentive is as follows:

Lessor Accounting

At inception:

Incentive to lessee	1,000	
Liability on sublease assumed		1,000

To record deferred cost and liability related to loss on assumption of remaining lease

Recurring journal entries in years 1-4:

Liability on sublease assumed (1,000/ 4 years)	250	
Sublease expense	550	
Cash		800

To record cash payment on sublease assumed and amortization of the liability on the sublease assumed

Cash	550	
Sublease revenue		550

To record cash received from sublease of the property

Recurring journal entries in years 1-8:

Cash	1,200	
Rental revenue		1,075
Incentive to lessee (1,000/ 8 years)		125

To record cash received on new lease and amortization of incentive over new lease term

Lessee Accounting

At inception:

Loss on sublease assumed by lessor	960	
Incentive from lessor		960

To record loss on sublease assumed in conjunction with new lease agreement

Recurring journal entries in years 1-8:

Lease expense	1,080	
Incentive from lessor (960/ 8 years)	120	
Cash		1,200

To record cash payment on new lease and amortization of incentive over the new lease term

Background

10. Some have suggested that incentives paid to or incurred on behalf of the lessee by the lessor are not part of the normal lessee-lessor relationship and should be recognized in income by the lessee in the period paid or incurred by the lessor. This Technical Bulletin views those incentives as an inseparable part of the new lease agreement that must be recognized as reductions to rental expense and rental revenue on a straight-line basis over the term of the new lease in accordance with paragraph 15 of Statement 13, Technical Bulletin 85-3, and paragraph 2 above.

## RELEVANT LITERATURE

### Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 25—Accounting for and Disclosures About Transactions with Affiliates and Other Related Party Transactions*
- *Issue Paper No. 34—Investment Income Due and Accrued*
- *Issue Paper No. 40—Real Estate Investments*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 8 and 22
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 8

- Minutes from the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force meeting on May 7, 1986, August 5, 1987, September 11, 1989 and December 4, 1989

### Generally Accepted Accounting Principles

GAAP guidance applicable to operating leases, sale-leaseback transactions and leveraged leases, which is adopted and rejected is indicated in brackets paragraphs:

- *FASB Statement No. 13, Accounting for Leases*, as amended and interpreted by incorporating FASB Statements, Interpretations, and Technical Bulletins, which follow. [paragraphs 15, 16.(b., c., d.), 19.(a., b.), 23.(b., c.), 36, 37, 38.b., 39.c., 42-47 adopted; all other paragraphs rejected]
- *FASB Statement No. 22, Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt (an amendment of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Statement No. 23, Inception of the Lease (an amendment of FASB Statement No. 13)* [paragraph 10 adopted; all other paragraphs rejected]
- *FASB Statement No. 27, Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases (an amendment of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Statement No. 28, Accounting for Sales with Leasebacks (an amendment of FASB Statement No. 13)* [adopted in its entirety, except guidance on capital leases is not applicable other than those leases that qualify as leveraged leases.]
- *FASB Statement No. 29, Determining Contingent Rentals (an amendment of FASB Statement No. 13)* [paragraphs 8, 11 adopted; remaining paragraphs rejected]
- *FASB Statement No. 98, Accounting for Leases:*
  - Sale-Leaseback Transactions Involving Real Estate*
  - Sales-Type Leases of Real Estate*
  - Definition of the Lease Term*
  - Initial Direct Costs of Direct Financing Leases (an amendment of FASB Statements No. 13, 66 and 91 and a recession of FASB Statement No. 26 and Technical Bulletin No. 79-11)* [paragraphs 1-13, 17-22.(a.-e., j.-n.) adopted; remaining paragraphs rejected]
- *FASB Statement No. 109, Accounting for Income Taxes* [paragraphs 256-258 adopted]
- *FASB Interpretation No. 19, Lessee Guarantee of the Residual Value of Leased Property (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 21, Accounting for Leases in a Business Combination (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 23, Leases of Certain Property Owned by a Governmental Unit or Authority (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 24, Leases Involving Only Part of a Building (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation No. 26, Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease (an interpretation of FASB Statement No. 13)* [rejected in its entirety]
- *FASB Interpretation 27, Accounting for a Loss on a Sublease (an interpretation of FASB Statement No. 13 and APB Opinion No. 30)* [adopted in its entirety]
- *FASB Technical Bulletin 79-10, Fiscal Funding Clauses in Lease Agreements* [rejected in its entirety.]
- *FASB Technical Bulletin 79-12, Interest Rate Used in Calculating the Present Value of Minimum Lease Payments* [rejected in its entirety]
- *FASB Technical Bulletin 79-13, Applicability of FASB Statement No. 13 to Current Value Financial Statements* [rejected in its entirety]
- *FASB Technical Bulletin 79-14, Upward Adjustment of Guaranteed Residual Values* [rejected in its entirety]
- *FASB Technical Bulletin 79-15, Accounting for Loss on a Sublease Not Involving the Disposal of a Segment* [adopted in its entirety]



- FASB Technical Bulletin 79-16(R), *Effect of a change in Income Tax Rate on the Accounting for Leveraged Leases* [adopted in its entirety]
- *FASB Technical Bulletin 79-17, Reporting Cumulative Effect Adjustment from Retroactive Application of FASB Statement No. 13* [rejected in its entirety]
- *FASB Technical Bulletin 79-18, Transition Requirement of Certain FASB Amendments and Interpretations of FASB Statement No. 13* [rejected in its entirety]
- *FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases* [adopted in its entirety]
- *FASB Technical Bulletin 86-2, Accounting for an Interest in the Residual Value of a Leased Asset:*
  - Acquired by a Third Party or*
  - Retained by a Lessor That Sells the Related Minimum Rental Payments* [adopted in its entirety]
- FASB Technical Bulletin 88-1, *Issues Related to Accounting for Leases:*
  - Time Pattern of the Physical Use of the Property in an Operating Lease*
  - Lease Incentives in an Operating Lease*
  - Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor*
  - Money-Over-Money Lease Transactions*
  - Wrap Lease Transactions*[paragraphs 1-12 adopted; remaining paragraphs rejected]

**State Regulations**

- No additional guidance obtained from state statutes or regulations.

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