

## **FASB CODIFICATION EXPECTED TO BECOME SINGLE SOURCE OF AUTHORITATIVE U.S. GAAP ON JULY 1, 2009**

United States accounting and reporting standards are undergoing a major restructuring, and preparers and auditors of financial reports need to be aware of, and prepared for, the significant changes that will occur next year. **On July 1, 2009, the *FASB Accounting Standards Codification*<sup>™</sup> is expected to become the single official source of authoritative, nongovernmental U.S. generally accepted accounting principles (GAAP), superseding existing FASB, AICPA, EITF, and related literature.** After that date, only one level of authoritative GAAP will exist, excluding the guidance issued by the Securities and Exchange Commission (SEC). All other literature will be non-authoritative.

The Codification does not change GAAP; instead, it introduces a new structure—one that is organized into an easily accessible, user-friendly online research system. The Codification reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting Topics, and displays all Topics using a consistent structure. Also included is relevant SEC guidance that follows the same topical structure used in the Codification.

The new system will:

- reduce the amount of time and effort required to solve an accounting research issue;
- mitigate the risk of noncompliance with standards through improved usability of the literature;
- provide accurate information with real-time updates as new standards are released; and
- assist the FASB with the research and convergence efforts required during the standard-setting process.

To prepare constituents for the change, the FASB offers a free online Codification tutorial at <http://asc.fasb.org>. In addition, there is a recorded webcast at [www.fasb.org](http://www.fasb.org). For more information, log on to [www.fasb.org](http://www.fasb.org).

### ***FASB Codification: Answers to commonly-asked questions***

#### ***How will U.S. accounting literature change on July 1, 2009?***

The Codification is a major restructuring of accounting and reporting standards. It will supersede all accounting standards in existing FASB, Emerging Issues Task Force (EITF), American Institute of Certified Public Accountants (AICPA), and related standards. At that time, only two levels of U.S. GAAP will exist: authoritative represented by the Codification, and nonauthoritative represented by all other literature. For reference by public companies, the Codification also includes SEC content, although the SEC content is displayed separately below the related topical content.

***Why did the FASB decide to embark on this major restructuring of existing accounting standards?***

Currently, there are thousands of standards by numerous standard-setters in various forms. Additionally, there is no defined organization within each standard to assist in retrieval. Users must read the entire standard to find relevant material.

Due to the dispersed nature of the current literature, many users of that literature do not feel comfortable that they have accessed all relevant material during their research. As a result, individuals may rely inadvertently on one piece of literature when another standard may be more relevant.

The Codification was launched to organize and simplify authoritative U.S. GAAP literature. All the authoritative literature related to a particular topic will be located in one place. Consequently, the Codification makes it much easier for preparers to research specific accounting issues.

***What literature is included?***

The Codification will include all level A–D GAAP issued by a standard setter, including pronouncements issued by the FASB, EITF, the Accounting Standards Executive Committee (AcSEC), the Accounting Principles Board, etc.

The source of material used to create the Codification is from the as-amended versions of accounting standards. Therefore, the Codification does NOT identify as sources any documents that solely amend other standards. For example, FASB Statement No. 149 is an amendment of FASB Statement No. 133, so the content of Statement No. 149 is included through the as-amended version of Statement No. 133.

***Does the Codification include SEC content?***

Yes. To increase the utility of the Codification for public companies, relevant portions of authoritative content issued by the SEC and selected SEC staff interpretations and administrative guidance have been included for reference in the Codification, such as Regulation S-X, Financial Reporting Releases (FRR)/Accounting Series Releases (ASR), Interpretive Releases (IR), and SEC staff guidance in Staff Accounting Bulletins (SAB), EITF Topic D, and SEC Staff Observer comments.

It is important to note that the SEC Sections contain SEC content related to matters within the basic financial statements, but the Codification does not contain the entire population of SEC rules, regulations, interpretive releases, and staff guidance. For example, the Codification does not include content related to matters outside of the basic financial statements, such as Management’s Discussion and Analysis (MD&A), or to auditing or independence matters.

Content in the SEC Sections is expected to change over time pursuant to the normal procedures of the SEC and SEC staff for making changes to SEC rules, regulations, interpretations, and staff guidance. The FASB intends to work with the SEC to make every effort to provide timely updates as SEC content changes. However, the SEC and SEC staff shall continue to use existing SEC procedures for communicating new or revised SEC content. Accordingly, there may be delays between SEC and SEC staff changes and corresponding updates to the Codification.

The Codification does not replace or affect requirements or guidance issued by the SEC or its staff for public companies in their filings with the SEC. In addition, as has been a long-standing SEC policy, SEC staff guidance does not constitute rules or interpretations of the SEC, nor does such guidance bear official Commission approval.

***Will the Codification include content that is not yet required for entities?***

Yes. The content from new standards that is not yet fully effective for all entities will appear as boxed text and labeled as "Pending Content." The Pending Content text box includes the earliest transition date and a link to the related transition guidance.

***What content is excluded from the Codification?***

The FASB concluded that the Codification represents authoritative GAAP. Therefore, the Codification does not include guidance for non-GAAP matters such as Other Comprehensive Basis of Accounting (OCBOA), Cash Basis, Income Tax Basis, and Regulatory Accounting Principles (RAP).

The Codification also does not include governmental accounting standards.

***How will one be able to find the original source of the Codification paragraphs?***

The Codification includes a Cross-reference report that allows users to identify where current standards reside in the Codification, or the source of material included in the Codification.

Users of the Codification can input the Codification reference, in which case the report will provide source information from current GAAP (e.g., standard type, number, and paragraph). Alternatively, a user can input the current GAAP source information to determine where the guidance exists in the Codification.

***How does someone find information about a particular issue in the Codification?***

There are three primary ways to get to the guidance related to a particular accounting issue. First, one can go directly to the Topic (e.g., Revenue Recognition) and then expand the Topic outline to find the relevant material. Secondly, the Codification includes a robust word search function. Finally, one can go directly to the Paragraph if the reference is known.

***How is the guidance arranged in the Codification?***

The Codification content is arranged within **Topics, Subtopics, Sections, and Subsections**.

**Topics** represent a collection of related guidance. The Topics correlate closely to standards issued by the International Accounting Standards Board (IASB).

Topics reside in four main areas as follows:

- *Presentation*—Topics relating only to presentation matters; they do not address recognition, measurement, and derecognition matters. Examples: Income Statement, Balance Sheet, and Earnings per Share.
- *Financial Statement Accounts*—The Codification organizes Topics into a financial statement order including Assets, Liabilities, Equity, Revenue, and Expenses. Topics include Receivables, Revenue Recognition, and Inventory.
- *Broad Transactions*—These Topics relate to multiple financial statement accounts and are generally transaction-oriented. Topics include Business Combinations, Derivatives, and Nonmonetary Transactions.
- *Industries*—These Topics relate to accounting that is unique to an industry or type of activity. Topics include Airlines, Software, and Real Estate.

**Subtopics** represent subsets of a Topic and are generally distinguished by type or by scope. For example, Operating Leases and Capital Leases are two Subtopics of the Leases Topic, distinguished by type of lease. Each Topic contains an Overall Subtopic that generally represents the pervasive guidance for the Topic. In other words, the Overall Subtopic includes guidance that applies to all other subtopics. Each additional Subtopic represents incremental or unique guidance not contained in the Overall Subtopic.

**Sections** represent the nature of the content in a Subtopic such as Recognition, Measurement, Disclosure, etc. The sectional organization for all Subtopics is the same. Similar to Topics, Sections correlate closely with sections of individual International Accounting Standards.

Sections are further broken down into **Subsections, Paragraphs, and Subparagraphs**, depending on the specific content of each Section.

***How are Topics, Subtopics, Sections, and Paragraphs classified?***

The FASB developed a hybrid classification system specifically for the Codification.

The following is the structure of the classification system:

XXX-YY-ZZ-PP where XXX = Topic, YY = Subtopic, ZZ = Section, PP = Paragraph.

In the case of SEC content, an "S" precedes the Section number.

***How will new standards be incorporated into the Codification?***

New standards will be composed of two items: the standard (similar to existing standards with a Basis for Conclusions) and an appendix of Codification Update instructions. The title of the combined set of standard and instructions will be "Codification Update YY-XX," where YY is the last two digits of the year and XX is the sequential number for each Update. For example, the combined numbers would be 09-01, 09-02, etc. All authoritative GAAP issued by the FASB will be issued in this format, regardless of the form in which such guidance may have been issued previously (for example, EITF Abstracts, FASB Staff Positions, FASB Statements, and FASB Interpretations).

The FASB will organize the content of new standards using the same Section headings as those used in the Codification. The Codification Update Instructions are similar to the Amendments sections of current FASB standards. They will display marked changes to the pertinent sections of the Codification.

Following the FASB Board's approval of the Codification as the single source of non-SEC authoritative accounting and reporting standards, the FASB will no longer consider new standards as authoritative in their own right. Instead, the new standards will serve only to update the Codification and provide the historical basis for conclusions of a new standard.

***Will new standards have a Basis for Conclusions? If so, how can it be accessed?***

Yes. The format will be the same as the format used currently. Upon adoption of the Codification as authoritative, users will be able to access the new standards and the related Basis for Conclusions.

***What happens to U.S. GAAP literature when the Codification goes live on July 1, 2009?***

All existing standards that were used to create the Codification will become superseded upon the adoption of the Codification. The FASB will no longer update and maintain the superseded standards. Also, upon adoption of the Codification, the U.S. GAAP hierarchy will flatten from five levels to two—authoritative and non-authoritative. The following table illustrates the result:

<b>U.S. GAAP Hierarchy</b>	<b>Authoritative Contained in Codification</b>	<b>Non-Authoritative Not contained in Codification</b>
Level A	X	
Level B	X	
Level C	X	

Level D – Issued by a standard setter	X	
Level D – Practice		X
Level E – Concept Statements, Textbooks, etc.		X

Note – As described in the Notice to Constituents, certain items currently included below level D have been included in the Codification.

***What happens to the Basis for Conclusions in standards issued before the Codification becomes authoritative?***

Similar to new standards addressed in the previous question, upon adoption of the Codification as authoritative, all existing standards will be superseded yet available for reference from the Codification website. The archived standards will include the original Basis for Conclusions.

***Does the Codification include grandfathered guidance for transactions scoped out of a newer standard (for example, APB 25 guidance scoped out of FAS 123(R))?***

In some cases, a new standard allows some or all entities to retain "old" guidance for a specific class of transactions (referred to as "grandfathered GAAP"). Those transactions typically occur before a cutoff date defined by the new standard. Upon initial release of the Codification, it will exclude grandfathered GAAP because entities can no longer apply the guidance to new transactions. The Codification will supersede all standards in effect upon its adoption. However, users will be able to reference those standards—including the grandfathered GAAP—within an archived section of the Codification website.

***What will be the search capabilities for locating archived standards?***

There will be two approaches to locating an archived standard. First, as noted previously, after the adoption of the Codification, archived standards will be accessible from the left navigation panel of the <http://asc.fasb.org> Web site. In this case, users will be able to browse the standards by standard setter, type, and number. This will be similar to the organization of most existing accounting research tools. Second, users will be able to use the text search feature to locate archived standards (in pdf format) that contain the search expression.

***How will the Codification fit into the FASB's work with the International Accounting Standards Board (IASB) to create a single set of converged, high-quality accounting standards?***

As mentioned previously, the Codification will assist the FASB with the research and convergence efforts required during the standard-setting process. The FASB is working with the IASB to determine the role of the Codification in a converged accounting world.

***Will there be a charge to access the Codification?***

A basic view of the Codification Topics will be accessible free of charge. For those who require an integrated professional product to minimize the time and effort needed to research U.S. GAAP, enhanced access to the Codification will be available as a subscription, providing high level search and retrieval functions, cross reference features, personal annotation, and dynamic linking capabilities.

***Will a print version of the Codification be issued as well?***

The FASB plans to issue the Codification in print. Details will be announced closer to the July 1, 2009 launch date. The FASB will evaluate whether to print future editions of the Codification based on the demand for the printed version.

***Where can I find out more specific information about how to use the Codification?***

The home page at <http://asc.fasb.org> includes various items of which users should be aware, including a “Notice to Constituents” that describes Codification-related matters. It also includes general information about how to use the online research system and special features such as *Cross Reference Reports* (to locate where standards reside), *Join Sections* (to join similar Sections from multiple Topics and Subtopics into a single document), and *Go To* (to jump directly to a specific Topic, Subtopic, Section, or Paragraph).

***Is Codification training available?***

The FASB offers an online tutorial, available by logging on to [www.fasb.org](http://www.fasb.org). The FASB website also includes an archived webcast offering step-by-step instructions

The American Institute of Certified Public Accountants (AICPA) also offers an archived webcast on the Codification. For more information, log on to [www.aicpa.org](http://www.aicpa.org).

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# ACCOUNTING FOR LEASES: UNDERSTANDING THE IMPACT OF ASC 842, LEASES

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## CASE DESCRIPTION

*The case seeks to contrast the lease accounting under the previous standard (ASC 840) and the guidance to be implemented in 2019 (ASC 842). The case is relevant for accounting majors especially those taking Intermediate Financial Accounting II. It is also relevant for business and finance majors dealing with corporate financial statements. It is also useful for professionals in practice/industry interested in how the new rules will affect their company. In the context of a hypothetical CFO and finance function of a domestic airline company, the case requires the performance of a web search and the procurement of information on former and current lease accounting. The case also requires the write-up of responses to questions comparing and contrasting the old and new guidance under ASC 840 and ASC 842, respectively; and, the creation of Right-of-Use Asset ("ROUA") and lease amortization schedules. The paper is suitable for undergraduate classes. Individuals or groups may be required to simply write-up their answers to the questions posed or present their research to the class for discussion and comment, especially with regard to the last, optional question. Completion of the case should require 5-10 hours outside of class. Classroom discussion should be about two hours.*

**JEL:** M41, M42

**KEYWORDS:** Lease Accounting, Accounting Standards Codification (ASC) 842, International Financial Reporting Standards (IFRS) 16, Airline Industry, Off-Balance Sheet Financing

## CASE INFORMATION

### Historically Problematic Nature of Lease Accounting

The accounting for leases has posed problems for decades. Since at least the late 1940s, accounting standard-setters have wrestled with the issues relating to lease accounting. In 1976, after more than 25 years of increasing pressure from users and the leasing industry, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") 13, Accounting for Leases. SFAS 13 became the much-amended basis of ASC 840 in the Accounting Standards Codification at its inception in 2009. The standard aimed to capitalize long-term financing leases on lessees' books, provided they met at least one or more of four very specific rules or tests.

The FASB amended SFAS 13 numerous times; the net effect of which became the now superseded ASC 840 – Leases. However, this failed to stem the tide of off-balance sheet ("OBS") financing because lessees managed to avoid the bright-line thresholds that undergirded the four, "bright line" rules or tests for whether a lease should be capitalized. The "bright line" rules or tests required on-balance sheet capitalization and recognition of the often-enormous lease assets and liabilities. How did lessees manage to avoid capitalizing leases? They found loopholes! Thus, lease accounting ultimately has the dubious honor of being the most frequently amended financial accounting standard. As a result, lease accounting



is frequently adduced as “Patient Zero” evidence of the failure of rule-based or “bright line” thresholds in accounting standards and of the need for principle-based standard setting.

In February 2016, as part of a multi-decade joint effort at convergence in lease accounting, the Financial Accounting Standards Board issued ASC 842, “Leases.”. The International Accounting Standards Board issued International Financial Reporting Standard 16, “Leases.” This guidance supersedes the preceding guideline ASC 840. For most companies these changes will take effect on January 1, 2019 but will take effect for public companies on December 15, 2018. ASC 842 changes the guidelines on how lessees and lessors report assets and liabilities on their balance sheet. The most pertinent aspect of ASC 842 is determining whether it is a finance lease or an operating lease and subsequently following the rules for asset/liability recognition.

To recap: SFAS 13 was the original US GAAP pronouncement that was amended and re-interpreted numerous times. ASC 840 was the Codification of SFAS 13 (as amended) in 2009. SFAS 13/ASC 840 comprises the former (“bright line”) way of accounting for leases under US GAAP. ASC 842 is the new/current, method of accounting for leases under US GAAP. It supersedes the SFAS 13/ASC840. IFRS 16 is the new/current version of international GAAP and a very close cousin of ASC 842. (See Question/Solution 10 for details on similarities and differences between ASC 842 and IFRS 16.)

### We Have to Do WHAT with Our Leases?

*The Company:* Table 1 provides a brief description of key operational and leasing facts and circumstances of a hypothetical domestic airline company, BlueSky Airlines.

Table 1: Brief Description of the Key Operational and Leasing Facts and Circumstances of BlueSky Air

1	BlueSky Air is a United States domiciled airline company that began operations in 2019.
2	Due to being relatively new to the industry, BlueSky Air does not have the financial wherewithal to buy a sufficient number of planes to conduct the volume of activity necessary for it to meet its budgeted goals. Therefore, they lease ten (10) of their 15 planes from Columbia Financial, Inc.
3	BlueSky Air was able to keep costs low by using a bank and operating under a 10-year lease that ends December 31, 2029 with an option to buy at the end. BlueSky Air is looking to expand their fleet by leasing five more planes; however, it is concerned about how the adoption of ASC 842 is going to affect their balance sheet. Additionally, BlueSky Air is concerned with the transition of their current leases to the new accounting standards.

*This table shows some of the key operational and leasing facts and circumstances of BlueSky Air.*

The Chief Accounting Officer (CAO) needs to know what the impact on assets and liabilities will be upon adoption of ASC 842. Table 2 notes the lease accounting guidance the CAO requires on several issues:

Table 2: Lease Accounting Guidance the CAO Requires

1	Is there still a net benefit to leasing instead of purchasing the aircraft?
2	Is it more advantageous to use a finance lease instead of an operating lease?
3	How will these new rules affect reported assets, liabilities, earnings, and ratios vs. the old rules?

*Table 2 displays the lease accounting guidance the CAO requires.*

The CAO has asked a member of the accounting staff to report on the new ASC 842 guidelines in order to bring the staff up to date.

*Lease Details:* Table 3 details the significant lease provisions with which BlueSky and their accounting function will have to contend.

Table 3: Lease Details

1	The term of the lease is ten years. The planes have an expected economic life of 20 years.
2	The planes have a fair value at the inception of the lease of \$54,554,859.79 <b>[this item can be omitted from the fact pattern]</b> with an unguaranteed residual value of \$24,503,130.96.
3	The expected residual value is greater than the guaranteed residual value.
4	BlueSky Air has an incremental borrowing rate of 8%, but Columbia Financial Inc. sets their annual rental rate to earn a rate of return of 6% per year. BlueSky Air knows this rate.
5	The lease agreement is non-cancelable, requiring equal annual payments in the amount of \$5,238,919.71 on January 1 of each year, for ten years, starting January 1, 2019.
6	BlueSky Air amortizes the right-of-use asset ("ROUA") on a straight-line basis.

*Table 3 notes important details of the plane lease including its term, estimated economic life and the relevant discount rates, among other items.*

## QUESTIONS

1. Access one of the Big Four/Global Eight public accounting firms and obtain the firm's publication on ASC 842. You are only looking for an overview of the guidance. The CAO only wants an introduction to the guidance not detailed information. Attach a file to your report with this information or publication for review by the CAO.
2. Indicate the ASC standard followed by BlueSky Air prior to the adoption of ASC 842. (Use of the ASC is preferred but current pre-convergence guidance from an Intermediate Accounting text should suffice.) What is the number of the newly minted IFRS standard that corresponds to ASC 842?
3. Describe the main differences when accounting for leases between the prior standards (ASC 840) and the standards to be implemented (ASC 842).
4. What are the lease classification tests for differentiating between a Finance lease and an Operating lease? Perform a lease classification test for the lease agreement described above.
5. Verify the calculation of the present value of lease payments for one of BlueSky Air's planes to determine the capitalized amount/ lease liability. (Use Columbia Financial's implicit rate of return.)
6. Create a Lease Amortization Schedule and a Right-of-Use Asset Amortization Schedule using the effective-interest method for one of BlueSky Air's leases.
7. Prepare journal entries on the books of BlueSky Air, as of January 1, 2019, for recording one of the leases and the first lease payment. Prepare the journal entry to record the lease expense, the increase in the lease liability and amortization of the ROUA as of December 31, 2019, on the books of BlueSky Air.
8. In your opinion, does the new method of accounting for leases provide a clearer picture of the company's financial position?
9. When using ASC 842, should the ASC 840 lease amounts be disclosed in a note to the financial statements or simply ignored?

Depending on the amount of time to be devoted to the case, the following step may be assigned.

1. Complete a review of four articles written by the Big Four discussing the pros and cons of the new standard. Specifically address the following issues:

- a. How will lessees recognize leases on the balance sheet? Address the lease liability initial value and subsequent measurement as well as the Right-of-Use Asset's initial value and subsequent measurement for finance and operating leases.
- b. What are the expanded quantitative and qualitative disclosures?
- c. What are the similarities and differences between the new lease accounting under US GAAP, ASC 842, as opposed to IFRS 16?

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## TEACHING NOTES

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## CASE DESCRIPTION

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## GENERAL COMMENTS

This case is designed to be used in an Intermediate Financial Accounting class. However, with slight modification, it might be useful to finance classes on financial statement analysis, a senior strategic management class, or an MBA financial management or financial reporting course. The case was developed for use in a country that uses US GAAP and the Accounting Standards Codification (ASC). However, the IASB and FASB standards are being developed in concert are thus very similar. Thus, the case can be modified to reflect IASB guidance. This case is not designed for students to understand the intricacies of lease accounting, but rather as an introductory look at the new process for, and basics of, lease accounting. Any changes to the standards will more likely than not change the approach under ASC 842 and the case would need to be modified appropriately.

## SOLUTIONS

**Question 1:** Access one of the Big Four/Global Eight public accounting firms and obtain the firm's publication on ASC 842. You are only looking for an overview of the guidance. The CAO only wants an introduction to the guidance not detailed information. Attach a file to your report with this information or publication for review by the CAO.

**Solution 1:** This step in the case allows the user to see that there are many sources of information about the IASB and FASB guidance.

Table 1: Listing of Relevant Publications Related to ASC 842 – Leases from Each of the Big Four Websites and Links to the Remainder of the “Global Eight”

a	PWC: <a href="https://www.pwc.com/us/en/cfodirect/publications/accounting-guides/pwc-lease-accounting-guide-asc-842.html">https://www.pwc.com/us/en/cfodirect/publications/accounting-guides/pwc-lease-accounting-guide-asc-842.html</a> . This link (PricewaterhouseCoopers, 2018) brings the user to the PWC site and gives them an option to download a guide or watch a video series.
b	Deloitte: <a href="https://www2.deloitte.com/us/en/pages/audit/articles/a-roadmap-to-applying-the-new-leasing-standard.html">https://www2.deloitte.com/us/en/pages/audit/articles/a-roadmap-to-applying-the-new-leasing-standard.html</a> . This link (Deloitte, 2019) brings the user to the Deloitte site that has both detailed guidance and summarized lease accounting guidance. There are also highlights for different aspects of the lease accounting process towards the bottom of the page (see also Deloitte, 2016).
c	KPMG: <a href="https://frv.kpmg.us/content/dam/frv/en/pdfs/2017/kpmg-handbook-leases.pdf">https://frv.kpmg.us/content/dam/frv/en/pdfs/2017/kpmg-handbook-leases.pdf</a> . This link (KPMG, 2017a) brings the user to a KPMG guide on the effect of the new standard on corporations. This link brings the user to the leasing rules and analysis under ASC 842.
d	EY: <a href="https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments_00195-171us_leaseaccounting_28august2019-v2/\$file/financialreportingdevelopments_00195-171us_leaseaccounting_28august2019-v2.pdf">https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments_00195-171us_leaseaccounting_28august2019-v2/\$file/financialreportingdevelopments_00195-171us_leaseaccounting_28august2019-v2.pdf</a> . This link (Ernst & Young, 2019) brings the user to the EY site and a downloadable guide on ASC 842..
e	The following link to several of remaining Global Ten professional accounting firms. Students can research their perspectives at their web sites. Some additional links are included in the References section.
1	Grant Thornton: <a href="https://www.granthornton.com/">https://www.granthornton.com/</a> ; Kratzke and Cherwin, 2016
2	BDO: <a href="https://www.bdo.com/">https://www.bdo.com/</a> ; BDO, 2018; BDO, 2019
3	RSM McGladrey: <a href="https://rsmus.com/what-we-do/services/assurance/featured-topics/lease-accounting-842.html">https://rsmus.com/what-we-do/services/assurance/featured-topics/lease-accounting-842.html</a> (RSM, 2019)
4	Baker Tilly: <a href="https://www.bakertilly.com/">https://www.bakertilly.com/</a> ; <a href="https://www.bakertilly.com/specialties/asc-842-lease-accounting">https://www.bakertilly.com/specialties/asc-842-lease-accounting</a> (Baker Tilly, 2019)

Table 1 provides a listing of relevant publications related to ASC 842 – Leases from each of the Big Four websites and the relevant websites of other large international public accounting firms.

**Question 2:** Indicate the ASC standard followed by BlueSky Air prior to the adoption of ASC 842. (Use of the ASC is preferred but current pre-convergence guidance from an Intermediate Accounting text should suffice.) What is the number of the newly minted IFRS standard that corresponds to ASC 842?

**Solution 2:** BlueSky previously followed ASC 840. The newly minted IFRS standard for leases is IFRS 16.

**Question 3:** Describe the main differences when accounting for leases between the prior standards (ASC 840) and the standards to be implemented (ASC 842).

**Solution 3:** The main differences between ASC 840 and ASC 842 are the recognition of assets and recording of liabilities for lessees on the balance sheet especially with regard to operating leases. Table 2 provides a summary of new lease accounting rules.

Table 2: Summary of New Lease Accounting Guidance under ASC 842

1	Lessees are required to recognize assets and liabilities for leases with lease terms of more than 12 months.
2	Leases will continue to be classified as a finance (formerly 'capital') or operating leases. However, BOTH finance AND operating leases will be recognized on the balance sheet.
3	Additional disclosures of a quantitative and qualitative nature to communicate better the amount, timing, and uncertainty of cash flows arising from leases are required.
4	Lessor accounting is largely unchanged. Improvements align lessor and lessee accounting consistent with the updated revenue recognition rules issued in 2014.
5	Impact on Financial Reporting:
a	Capitalizing leases will have a significant impact on recognition of assets and liabilities on the balance sheet for a wide variety of companies. This will change balance sheets, net income, and various ratios but will NOT affect cash flows. There will be increases in EBITDA, Total Assets, Total Liabilities and Leverage ratios. There will be decreases (increases) in EPS in earlier (later) years, Net Assets, and Interest Coverage and Asset Turnover ratios.
b	Financial Management (Rowe, 2017) estimated that companies listed on major stock exchanges have a combined \$3 trillion in leasing commitments over 85 percent of which are not reported on the companies' balance sheets under ASC840. Due to differing financing structures, risk to the system is heightened via a lack of transparency and of comparability.
c	It is anticipated that the industries where this will have the biggest impact on companies' income before taxes are retail, telecommunications, information technology, transportation, construction, and agriculture. However, any company that has lease agreements will be affected.

*This table provides a listing of some of the key elements of the accounting rules under the recently implemented ASC 842. (See KPMG, 2017a; KPMG, 2018a; KPMG, 2018b).*

**Question 4:** What are the lease classification tests for differentiating between a Finance lease and an Operating lease? Perform a lease classification test for the lease agreement described above.

**Solution 4:** The lease classification tests for differentiating between a Finance lease and an Operating lease are listed on p. 339 of KPMG, 2017a.

If the answer to any one of the questions at the citation above is "yes"/if any of the lease characteristics listed above applies, the lessee classifies the lease as a finance lease. If the answer to ALL one of the questions is "no"/if none of the lease characteristics listed above applies, the lessee classifies the lease as an operating lease. Table 3 analyzes the BlueSky lease against the classification tests under ASC 842.

Table 3: Analysis of Lease Classification Tests Applied to BlueSky

1	Transfer of ownership test: The lease does <i>not</i> transfer ownership to BlueSky Air.
2	Purchase option test: Columbia Financial does <i>not</i> allow for an option to purchase the asset that BlueSky Air is reasonably certain to exercise.
3	Lease term test: The lease term is half the asset's (10 out of 20 years) economic life. This does <i>not</i> meet the general threshold of 75% of the estimated economic life of the leased asset for classification as a finance lease.
4	Present value test: The lease does <i>not</i> pass the present value test because the present value of the sum of the lease payments does <i>not</i> equal or exceed substantially all of the underlying asset's fair value (using the 90% threshold). Note: the lessee residual value is unguaranteed and therefore not included in the present value computation for purposes of lease classification.
5	Alternative use test: Because the asset could potentially be leased out to a different airline following the life of the lease, it does <i>not</i> meet the "no alternative use" test.

Based on the above information, the lease does not meet any of the finance lease classification criteria. Therefore, it would be classified as an operating lease.

*This table analyzes the BlueSky plane lease against the classification criteria of ASC 842. It concludes the lease does not meet any of the finance lease classification criteria and that it would be classified as an operating lease.*

**Question 5:** Verify the calculation of the present value of lease payments for one of BlueSky Air's planes to determine the capitalized amount/ lease liability. (Use Columbia Financial's implicit rate of return.)

**Solution 5:** See Table 4

Table 4: Calculation of the Present Value of Lease Payments to Determine Capitalized Amount and Lease Liability

N	I	PV	PMT	PV
10	6%	54,554,860	(5,238,920)	(24,503,131)
Date	Annual Payment	Interest (6%) on Liability	Reduction of Lease Liability	Capitalized Amount/Lease Liability
1/1/2019				54,554,860
1/1/2019	5,238,920	-	5,238,920	49,315,940
1/1/2020	5,238,920	2,958,956	2,279,963	47,035,977
1/1/2021	5,238,920	2,822,159	2,416,761	44,619,216
1/1/2022	5,238,920	2,677,153	2,561,767	42,057,449
1/1/2023	5,238,920	2,523,447	2,715,473	39,341,976
1/1/2024	5,238,920	2,360,519	2,878,401	36,463,575
1/1/2025	5,238,920	2,187,814	3,051,105	33,412,470
1/1/2026	5,238,920	2,004,748	3,234,172	30,178,298
1/1/2027	5,238,920	1,810,698	3,428,222	26,750,076
1/1/2028	5,238,920	1,605,005	3,633,916	23,116,161
1/1/2029	-	1,386,970	-1,386,970	24,503,131

*This table shows that the capitalized amount/lease liability are \$24,503,131.*

**Question 6:** Create a Lease Amortization Schedule and a Right-of-Use Asset Amortization Schedule using the effective-interest method for one of BlueSky Air's leases.

**Solution 6:** See Table 5 and Table 6

Table 5: Lease Liability

Date	Annual Payment	Interest (6%) on Liability	Reduction of Lease Liability	Capitalized Amount/Lease Liability
1/1/2019				54,554,860
1/1/2019	5,238,920	-	5,238,920	49,315,940
1/1/2020	5,238,920	2,958,956	2,279,963	47,035,977
1/1/2021	5,238,920	2,822,159	2,416,761	44,619,216
1/1/2022	5,238,920	2,677,153	2,561,767	42,057,449
1/1/2023	5,238,920	2,523,447	2,715,473	39,341,976
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1/1/2025	5,238,920	2,187,814	3,051,105	33,412,470
1/1/2026	5,238,920	2,004,748	3,234,172	30,178,298
1/1/2027	5,238,920	1,810,698	3,428,222	26,750,076
1/1/2028	5,238,920	1,605,005	3,633,916	23,116,161
1/1/2029	-	1,386,970	-1,386,970	24,503,131



Table 6: Right-of-Use Asset Amortization Schedules

Date	Lease Expense (Straight Line)	Interest (6%) on Liability	Amortization of Right-of- Use Asset (ROUA)	Carrying Value of (ROUA)
1/1/2019				54,554,860
1/1/2019	5,238,920	-	5,238,920	49,315,940
1/1/2020	5,238,920	2,958,956	2,279,963	47,035,977
1/1/2021	5,238,920	2,822,159	2,416,761	44,619,216
1/1/2022	5,238,920	2,677,153	2,561,767	42,057,449
1/1/2023	5,238,920	2,523,447	2,715,473	39,341,976
1/1/2024	5,238,920	2,360,519	2,878,401	36,463,575
1/1/2025	5,238,920	2,187,814	3,051,105	33,412,470
1/1/2026	5,238,920	2,004,748	3,234,172	30,178,298
1/1/2027	5,238,920	1,810,698	3,428,222	26,750,076
1/1/2028	5,238,920	1,605,005	3,633,916	23,116,161
1/1/2029	-	1,386,970	-1,386,970	24,503,131

*These tables show the amortization patterns for the lease liability and Right-of-Use Asset under the BlueSky plane lease.*

**Question 7:** Prepare journal entries on the books of BlueSky Air, as of January 1, 2019, for recording one of the leases and the first lease payment. Prepare the journal entry to record the lease expense, the increase in the lease liability and amortization of the ROUA as of December 31, 2019, on the books of BlueSky Air.

**Solution 7:** The entries are as follows:

	<b>1/1/2019</b>	
Right-of-Use Asset	54,554,860	
Lease Liability		54,554,860

To record Right-of Use Asset and related lease liability at inception of lease. See calculation of present value of lease payments.

Lease Expense	5,238,920	
Cash		5,238,920

To record initial rent payment on lease aircraft

	<b>12/31/2019</b>	
Lease Expense	5,238,920	
Lease Liability		2,958,956
Right-of-Use Asset		2,279,963

To record interest component and amortization component Right-of-Use Asset (These are separate under IFRS)

**Question 8:** In your opinion, does the new method of accounting for leases provide a clearer picture of the company's financial position?

**Answer 8:** Students may have a variety of answers. The answer with the most support should be one that says the substance of the company's financial position as a result of the leasing transactions it has entered into is more clearly conveyed under the new lease accounting guidance of ASC 842.

The new lease accounting rules were created via an exhaustive process commencing in 2006 at the request of investors, regulators, ratings agencies, and other financial statement users for more faithful representation of the substance of leasing activities, and reflect their input in the form of numerous drafts exposed for comment and hundreds of comments. Specifically, critics of ASC 840 lease accounting viewed the off-balance sheet motivation and element of lessee lease accounting to be an egregious failure to capture the substance of long-term leasing transactions. To that end, the new lease accounting rules end the widespread practice of conforming to bright-line rules for capitalizing in form but not in substance. Now, companies will be required to recognize assets and liabilities associated with nearly all lease activities (there are exceptions of short term and low dollar value leases).

In addition, similar to many recent pronouncements by accounting rule-makers, disclosure of leasing transactions have been greatly enhanced, requiring more qualitative and quantitative disclosures which should better inform financial statement users and assist them in better assessing the amount, timing and uncertainty of future cash flows arising from leasing transactions.

**Question 9:** When using ASC 842, should the ASC 840 lease amounts be disclosed in a note to the financial statements or simply ignored?

**Answer 9:** Per KPMG, 2019, "Lessees have a choice of adopting ASC 842 by restating comparatives (comparative method) or without restating comparatives (effective date method)." In the comparative method, prior period amounts are restated to conform to ASC 842. Under the effective date method, prior period amounts are not restated.

The following step may or may not be assigned depending on the amount of time desired.

**Question 10:** Complete a review of four articles written by the Big Four discussing the pros and cons of the new standard. Specifically address the following issues:

a-How will lessees recognize leases on the balance sheet? Address the lease liability initial value and subsequent measurement as well as the Right-of-Use Asset's initial value and subsequent measurement for finance and operating leases.

b-What are the expanded quantitative and qualitative disclosures?

c-What are the similarities and differences between the new lease accounting under US GAAP, ASC 842, as opposed to IFRS 16?

**Solution 10:** Answers will vary based on the resources accessed. The References lists typical sources. References such as KPMG, 2016; KPMG, 2017a; KPMG, 2018a; and KPMG, 2018b, respectively, will be useful to the Instructor for responding to items a and b, above. Item c responses should incorporate the US GAAP/IFRS similarities and differences identified in KPMG, 2017b, KPMG, 2018c, and PricewaterhouseCoopers, 2018b, respectively.

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## ACCOUNTING & FINANCE

by Olga Darlington and Julie Desimone

# Regulatory accounting can serve as a tool for rate setting

**D**o you remember the unplanned series of events that occurred in 2001: the California brown and blackouts, sun setting of contracts, and significant spikes in the power markets, just to name a few? For the majority of utilities, especially power, this set of events caused utilities to expend millions of dollars that were not currently included in rate base. This set of events became the poster child for the use of regulatory accounting.

We frequently talk about utilities being unique entities because of the distinctive environment in which they operate. That distinctive environment is often described as monopolistic due to defined service territories allowing utilities to have a stable customer base, and their ability to set customer rates. To ensure that customer interests are protected, utilities are subjected to regulation, limiting their rate-setting capability to recovering the cost of providing service and fair return on capital. All utilities are regulated when it comes to rate-setting authority — sometimes that role is served by the state regulatory agency, and sometimes that regulator is the utility's own board of directors or commission.

Regulation of the rate-setting process provides a unique financial and economic aspect and has its accounting consequences. Regulatory accounting is a tool that is used by utilities to bridge the gap between cost incurred in one period that may benefit future periods, and the intent to recover those costs from customers over time through rates. It is a key matching principle of cost incurred and revenues collected for financial reporting purposes.

The primary source of industry-specific accounting guidance for regulated operations was outlined in SFAS 71, *Accounting for the Effects of Certain Types of Regulation*, currently codified into ASC 980, *Regulated Operations*. Governmental entities had no specific guidance for regulated operations prior to 2010 when GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting*.

*Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, which includes a section on regulated operations incorporating many concepts of ASC 980. In today's economic environment hardly any utility does not invoke the use of regulatory accounting.

Action of a regulator that approves rates for the utility is required in order for regulatory accounting to be used for financial reporting. Once a regulator approves cost of service recovery through rates, application of regulatory accounting will result in recognition of a regulatory asset on the entity's balance sheet. Regulatory assets are established when certain expenditures are set up as deferrals rather than being recorded as period expenses. Amounts deferred as regulatory assets are then amortized over an expected period of recovery through rates. As soon as the entity determines that recovery is no longer probable, the remaining amounts should be written off as period costs. As such, the utility's rate structure should reflect the actual costs being recovered at any given point. The most common examples of costs generally deferred as regulatory assets are power/fuel cost subject to PCA; storm damage and infrequent maintenance expenditures; environmental clean-up costs; and asset impairment charges. Regulatory liability arises when a regulator requires a utility to refund amounts previously collected from the customers or when revenues are being currently collected to cover anticipated future cost. Common examples of regulatory liabilities are rate stabilization funds and, on the governmental side, deferral of large contribution in aid of construction revenues to match depreciation expenses through the life of assets.

The primary benefit to regulatory accounting is the matching of revenues and expenses; however, there are some distinct challenges that arise. First, before any costs are included in rates for recovery, they must be approved by the regulator. The regulator can disallow the recovery of certain costs, which would cause their immediate recognition in earn-

Utility	Regulatory asset	Total assets	Percent of total assets	Regulatory liability	Total liabilities	Percent of total liabilities
A	\$566,631,000	\$4,313,179,000	13.1%	\$318,643,000	\$3,031,106,000	10.5%
B	\$1,543,859,000	\$12,801,579,000	12.1%	\$1,737,326,000	\$9,317,351,000	18.6%
C	\$42,728,000	\$1,590,470,000	2.7%	\$22,336,000	\$1,116,424,000	2.0%
D	\$112,548,605	\$3,241,256,333	3.47%	\$15,477,613	\$2,188,848,314	0.7%

*The above are actual examples from utilities. The information was pulled from either the utility's 2012 Annual Form 10-K filed with the SEC or the utility's 2012 annual report posted on its website. Chart provided by Moss Adams LLP.*

*As the utility business continues to become more dynamic, the use of regulatory accounting is an essential tool to deal with unexpected outcomes, or differences between accounting standards and rate setting.*

ings. In most cases, the regulator has determined these costs were not prudent to recover from rate payers. Accounting for regulatory accounting can result in extensive tracking and effort. Each regulatory asset or liability will have different recovery periods, which may result in extensive recordkeeping to keep track of each individual regulatory asset and liability. The accounting standards also require that each type of regulatory asset or liability be disclosed in enough detail so that

the reader of the financial statements understands the type of regulatory asset and liability.

We believe the use of regulatory accounting will continue to increase. There is currently, and will continue to be, an increase in new accounting standards that require recording of liabilities and expenses that do not meet cash flows (pension accounting, asset retirement obligations, etc.) and many utilities set rates to cover current cash flows. As the utility business continues to become more dynamic, the use of regulatory accounting is an essential tool to deal with unexpected outcomes, or differences between accounting standards and rate setting. **NWPPA**

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Viewpoint

# 1.3 Comparison of ASC 842 and ASC 840

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US Leases guide 1.3

Figure LG 1-2 summarizes the significant differences between ASC 842 and the previous guidance in ASC 840.

Figure LG 1-2

Changes to lease accounting under ASC 842

Topic	ASC 842 guidance	Observations
Definition of a lease	An arrangement is a lease or contains a lease only when such arrangement conveys the right to “control” the use of an “identified asset” to a customer and the customer obtains substantially all its economic benefits	<p>Under ASC 840, an arrangement can contain a lease even without control of the use of the asset if the customer takes substantially all of the output over the term of the arrangement.</p> <p>Determining whether an arrangement contains a lease is likely to be more important since virtually all leases will require recognition of an asset and liability by a lessee. It will also make the allocation of contractual consideration between lease and nonlease components a critical element of the accounting analysis for many reporting entities.</p>
Lessee accounting	There are no bright lines and there is one additional criterion regarding the specialized nature of the underlying asset for lease classification	The lack of explicit bright lines will increase the level of judgment required when classifying a lease – particularly for certain highly structured transactions. Despite the removal of the bright lines, the guidance in ASC 842-10-55-2 acknowledges that one reasonable approach to determining whether the lease is for a major portion of the asset’s remaining economic life and whether lease payments represent substantially all of the asset’s fair value is the 75% and 90% thresholds applicable in ASC 840.
	Lessees will recognize a right-of-use asset and a lease liability for virtually all leases	Reflecting nearly all leases on the balance sheet is the biggest change, and one of the key objectives of the guidance in ASC 842.
	Expense will be recognized on a straight-line basis for an operating lease. This is accomplished by increasing the amortization of the right-of-use asset as the imputed interest on the liability declines over the lease term. Recognition of expense for a finance lease will be similar to capital leases in ASC 840.	Under ASC 840, operating leases are off-balance sheet. Under ASC 842, the accounting for an operating lease will backload amortization of the right-of-use asset, potentially increasing the risk of an impairment. Once impaired, the right-of-use asset in an operating lease will be amortized on a straight-line basis, which will result in an expense recognition pattern similar to a finance lease.



Lessor accounting	<p>The classification criteria are similar to that for lessees, with an additional requirement to assess collectibility to support classification as a direct financing lease. Also, in order to derecognize the asset and record revenue, collection of payments due must be probable for sales-type leases.</p> <p>To recognize upfront revenue and profit in a sales-type lease, the lessee will need to obtain control over the leased asset.</p> <p>Leases otherwise classified as a sales-type or direct financing lease must be accounted for as an operating lease if they contain variable lease payments that don't relate to a rate or index and would result in recognition of a day-one loss. This accounting model is similar to ASC 840.</p>	<p>Under ASC 840, to achieve sales-type lease accounting for real estate, title must automatically transfer to the lessee by the end of the lease term. This condition has been removed from the guidance in ASC 842.</p> <p>In ASC 840, the difference between a sales-type lease and a direct finance lease is the presence of upfront profit. When present, the arrangement is a sales-type lease.</p> <p>Under ASC 842, the key distinction is based on control. As a practical matter, this will likely depend on whether the lease payments criterion has been met in part due to a third-party residual value guarantee. When this is the case, assuming payments are collectible, the lease is classified as a direct financing lease.</p>
Lease versus nonlease components	<p>A contract may contain lease and nonlease components. Under ASC 842, components include only those items or activities that transfer a good or service to the lessee. The right to use land is considered a separate lease component unless the accounting effect of accounting for it separately would be immaterial.</p> <p>A lessee may choose not to separate nonlease components from their associated lease components. If this election is made, all cash flows associated with the nonlease component would be allocated to the associated lease component. A lessor may elect to combine nonlease and associated lease components when the timing and pattern of transfer of the components are identical, and the lease classification would have been an operating lease absent the combination. If elected, the combined components would be accounted for under ASC 842 only if the nonlease component is not predominant.</p>	<p>Under ASC 840, property taxes and insurance are considered executory costs. Under ASC 842, property taxes and insurance are not considered as components of a contract as they are not for a service provided by the lessor to the lessee, and are therefore a part of contract payments if the contract requires the lessee to reimburse the lessor for those costs.</p> <p><b>Under ASC 840, land is separately classified when the fair value of the land is 25% or more of the combined fair value of the land and building.</b></p>
Inception date versus commencement date	<p><b>Under ASC 842, the determination of whether or not a contract is a lease or contains a lease is done at the inception date.</b> Lease classification is determined, and the lease is recognized and measured, at the lease commencement date.</p>	<p>Under ASC 840, assumptions relevant to classification and measurement are determined at lease inception. Recognition of rent expense or capital lease assets and liabilities begin at the commencement date.</p>
Initial direct costs	<p>Under ASC 842, initial direct costs are defined as incremental costs of a lease that would not have been incurred if the lease had not been obtained.</p>	<p>Under ASC 840, incremental direct costs can include internal costs as well as external costs such as legal fees, even if incurred before the lease was obtained. Therefore, certain incremental costs previously eligible for capitalization will be expensed under ASC 842.</p>
Build-to-suit arrangements	<p>Ownership during construction period is based on a control model.</p>	<p>ASC 840 guidance is based on a risks and rewards model, but contains several complex prescriptive provisions designed to assess lessee ownership during construction. The ASC 842 model has eliminated these prescriptive rules and replaced them with a model based on control.</p> <p>Under ASC 840, build-to-suit accounting applies only to lessees. Under ASC 842,</p>

build-to-suit accounting also applies to lessors. Attachment D

Sale and leaseback transactions	<p>Under <b>ASC 842</b>, a sale and leaseback transaction will qualify as a sale only if:</p> <ul style="list-style-type: none"> <li>● it meets the sale guidance in the revenue standard,</li> <li>● the leaseback is not a finance lease for a lessee or a sales-type lease for a lessor, and</li> <li>● if there is a repurchase option, <ul style="list-style-type: none"> <li>○ the repurchase price is at the underlying asset's fair value at the time of exercise and</li> <li>○ alternative assets that are substantially the same as the transferred asset are readily available in the marketplace.</li> </ul> </li> </ul>	<p>Under <b>ASC 840</b>, sale and leaseback accounting is applicable only to lessees. This includes detailed and specialized guidance applicable to sale and leasebacks involving real estate.</p> <p>Under <b>ASC 842</b>, sale and leaseback accounting will apply to lessees and lessors. A "failed" sale is treated as a financing by both the lessee and lessor (i.e., the seller has not sold the asset but has essentially mortgaged it). There is no specialized guidance for sale and leasebacks of real estate. However, a sale and leaseback for real estate that includes a repurchase option will likely fail sale accounting (as it did before <b>ASC 842</b>) because all real estate is unique and no other asset would be substantially the same.</p> <p>Sale and leaseback transactions involving equipment frequently have fixed price repurchase options – often at the request of the seller-lessee for commercial reasons. Such transactions will not qualify as a sale under the new standard. However, sale and leaseback accounting applied for transactions executed prior to the application date of <b>ASC 842</b> will not need to be reevaluated. Existing "failed" sale and leaseback transactions will be evaluated under the new standard and may qualify for sale and leaseback accounting on transition.</p>
Lessee reassessment	<p>A lessee is required to reassess the lease term if a triggering event occurs that is under the lessee's control or an option is exercised/not exercised as planned or an event written in the contract occurs that obligates the lessee to exercise/not exercise an extension or termination option. A change to the lease term will lead to a reassessment of lease classification and remeasurement of the lease liability and right-of-use asset. Assumptions such as the discount rate, fair value of the underlying asset, and variable rents based on a rate or index will be updated as of the remeasurement date.</p>	<p><b>ASC 840</b> does not require a reassessment of lease classification unless the lease is modified or an option is exercised. Under <b>ASC 842</b>, a lessee will need to monitor for triggering events on an ongoing basis.</p>
Modification	<p>A lease modification is a change to the contractual terms and conditions of a lease that was not part of the original lease. A modification that grants the lessee an additional right of use priced at market is a separate lease that is then classified at the lease modification date. For all other modifications, entities may have to reassess whether the arrangement contains a lease, reallocate contract consideration between the lease and nonlease components, reassess lease classification, and remeasure the lease liability and right-of-use asset prospectively. Assumptions such as the discount rate, fair value of the underlying asset, and variable rents based on a rate or index will be updated as of the modification date.</p>	<p>Lease modifications under <b>ASC 840</b> can be complex and difficult to differentiate from a termination of a lease contract. A renewal or extension is considered a new lease. All other changes are subject to a two-step evaluation of the lease.</p>



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Financial Accounting Standards Board

# ORIGINAL PRONOUNCEMENTS

AS AMENDED

## Statement of Financial Accounting Standards No. 13

Accounting for Leases

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# Statement of Financial Accounting Standards No. 13

## Accounting for Leases

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## FAS13

## FASB Statement of Standards

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FIN 21

FIN 23

FIN 24

FIN 26

FIN 27

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FTB 79-15

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## Accounting for Leases

# Statement of Financial Accounting Standards No. 13

## Accounting for Leases

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### INTRODUCTION

1. This Statement establishes standards of financial accounting and reporting for leases by lessees and lessors. For purposes of this Statement, 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. It includes agreements that, although not nominally identified as leases, meet the above definition, such as a “heat supply contract” for nuclear fuel.<sup>1</sup> 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. 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 this

Statement even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets. This Statement does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, and timber. Nor does it apply to licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights.

2. This Statement supersedes *APB Opinion No. 5*, “Reporting of Leases in Financial Statements of Lessee”; *APB Opinion No. 7*, “Accounting for Leases in Financial Statements of Lessors”; paragraph 15 of *APB Opinion No. 18*, “The Equity Method of Accounting for Investments in Common Stock”; *APB Opinion No. 27*, “Accounting for Lease Transactions

<sup>1</sup>Heat supply (also called “burn-up”) contracts usually provide for payments by the user-lessee based upon nuclear fuel utilization in the period plus a charge for the unrecovered cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service other than the financing.

by Manufacturer or Dealer Lessors”; and *APB Opinion No. 31*, “Disclosure of Lease Commitments by Lessees.”

3. [This paragraph has been deleted. See Status page.]

4. Appendix A provides background information. Appendix B sets forth the basis for the Board’s conclusions, including alternatives considered and reasons for accepting some and rejecting others. Illustrations of the accounting and disclosure requirements for lessees and lessors called for by this Statement are contained in Appendixes C and D. An example of the application of the accounting and disclosure provisions for leveraged leases is provided in Appendix E.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Definitions of Terms

5. For purposes of this Statement, certain terms are defined as follows:

- a. *Related parties in leasing transactions.* 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 company, or investor has the ability to exercise significant influence over operating and financial policies of the related party, as significant influence is defined in *APB Opinion No. 18*, paragraph 17. 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 entities are subject to the significant influence of a parent, owner company, investor (including a natural person), or common officers or directors, those entities shall be considered related parties with respect to each other.
- b. *Inception of the lease.* The date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the

principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

- c. *Fair value of the leased property.* The price for which the property could be sold in an arm’s-length transaction between unrelated parties. (See definition of related parties in leasing transactions in paragraph 5(a).) The following are examples of the determination of fair value:
  - i. When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease (as defined in paragraph 5(b)) 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.
  - ii. 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. (See paragraph 6(b).)
- d. *Bargain purchase option.* A provision allowing the lessee, at his option, to purchase the leased property for a price which 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.
- e. *Bargain renewal option.* A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental<sup>2</sup> 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.

<sup>2</sup>“Fair rental” in this context shall mean the expected rental for equivalent property under similar terms and conditions.

## Accounting for Leases

- f. *Lease term.* The fixed noncancelable term of the lease plus (i) all periods, if any, covered by bargain renewal options (as defined in paragraph 5(e)), (ii) all periods, if any, for which failure to renew the lease imposes a penalty (as defined in paragraph 5(o)) on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (iii) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property<sup>2a</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, (iv) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph 5(d)) is exercisable, and (v) all periods, if any, representing renewals or extensions of the lease at the lessor's 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 (a) only upon the occurrence of some remote contingency, (b) only with the permission of the lessor, (c) only if the lessee enters into a new lease with the same lessor, or (d) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured shall be considered "noncancelable" for purposes of this definition.
- g. *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.
- h. *Estimated residual value of leased property.* The estimated fair value of the leased property at the end of the lease term (as defined in paragraph 5(f)).
- i. *Unguaranteed residual value.* The estimated residual value of the leased property (as defined in paragraph 5(h)) exclusive of any portion guaranteed by the lessee<sup>3</sup> or by a third party unrelated to the lessor.<sup>4</sup>
- j. *Minimum lease payments.*
- i. 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.<sup>4a</sup> However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes 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 5(f)) 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:
- (a) The minimum rental payments called for by the lease over the lease term.
  - (b) Any guarantee by the lessee<sup>5</sup> 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. 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 below a stated amount in the lessor's realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made up.
  - (c) 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 leased property. In this connection, it should be noted that the definition of

<sup>2a</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 lessor's 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 lessor's debt on behalf of the lessee, or the lessee financing the lessor's purchase of the leased asset using collateral other than the leased property.

<sup>3</sup>A guarantee by a third party related to the lessee shall be considered a lessee guarantee.

<sup>4</sup>If the guarantor is related to the lessor, the residual value shall be considered as unguaranteed.

<sup>4a</sup>Contingent rentals as defined by paragraph 5(n) of *FASB Statement No. 13* shall be excluded from minimum lease payments.

<sup>5</sup>See footnote 3.



- lease term in paragraph 5(f) 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 minimum lease payments.
- ii. From the standpoint of the lessor: The payments described in (i) 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<sup>6</sup> or the lessor,<sup>7</sup> provided the third party is financially capable of discharging the obligations that may arise from the guarantee.
  - k. *Interest rate implicit in the lease.* The discount rate that, when applied to (i) the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and (ii) the unguaranteed residual value (as defined in paragraph 5(i)) accruing to the benefit of the lessor,<sup>8</sup> causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property (as defined in paragraph 5(c)) 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, e.g., see paragraph 44.)
  - l. *Lessee’s 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.
  - m. *Initial direct costs.*<sup>8a</sup> Only those costs incurred by the lessor that are (a) costs to originate a lease incurred in transactions with independent third parties that (i) result directly from and are essential to acquire that lease and (ii) would not have been incurred had that leasing transaction not occurred and (b) certain costs directly related to specified activities performed by the lessor for that lease. Those activities are: evaluating the prospective lessee’s financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating lease terms; preparing and processing lease documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees’ total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs shall not include costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Initial direct costs shall not include administrative costs, rent, depreciation, any other occupancy and equipment costs and employees’ compensation and fringe benefits related to activities described in the previous sentence, unsuccessful origination efforts, and idle time.
  - n. *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 pre-construction period, as discussed in *FASB Statement No. 23, “Inception of the Lease,”* 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

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<sup>6</sup>See footnote 3.

<sup>7</sup>See footnote 4.

<sup>8</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 his benefit.

<sup>8a</sup>Initial direct cost shall be offset by nonrefundable fees that are yield adjustments as prescribed in *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*



## Accounting for Leases

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.

- o. *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.

### Classification of Leases for Purposes of This Statement

6. For purposes of applying the accounting and reporting standards of this Statement, leases are classified as follows:

- a. Classifications from the standpoint of the lessee:
  - i. *Capital leases.* Leases that meet one or more of the criteria in paragraph 7.
  - ii. *Operating leases.* All other leases.
- b. Classifications from the standpoint of the lessor:
  - i. *Sales-type leases.* Leases that give rise to manufacturer's or dealer's profit (or loss) to the lessor (i.e., 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 7 and both of the criteria in paragraph 8, 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 7(a), in which case the criteria in paragraph 8 do not apply. 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 7 and 8, but will most often be direct financing leases, described in paragraph 6(b)(ii) below. However, a lessor need not be a dealer to realize dealer's profit (or loss) on a transaction, e.g., 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. A renewal or an extension<sup>9</sup> 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<sup>9a</sup> specified in the existing lease, in which case it shall be classified as a sales-type lease. (See paragraph 17(f).)

- ii. *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 7 and both of the criteria in paragraph 8. 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. An exception arises when an existing sales-type or direct financing lease is renewed or extended<sup>10</sup> during the term of the existing lease. 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. (See paragraph 17(f).)
- iii. *Leveraged leases.* Leases that meet the criteria of paragraph 42.
- iv. *Operating leases.* All other leases, including leases that involve real estate and give rise to

<sup>9</sup>As used here, renewal or extension includes a new lease under which the lessee continues to use the same property.

<sup>9a</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.

<sup>10</sup>See footnote 9.

manufacturer's or dealer's profit (or loss) to the lessor but do not meet the criterion in paragraph 7(a).

### Criteria for Classifying Leases (Other Than Leveraged Leases)

7. The criteria for classifying leases set forth in this paragraph and in paragraph 8 derive from the concept set forth in paragraph 60. If at its inception (as defined in paragraph 5(b)) 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. (See Appendix C 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 (as defined in paragraph 5(f)).<sup>10a</sup>
- b. The lease contains a bargain purchase option (as defined in paragraph 5(d)).
- c. The lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)). 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 at the beginning of the lease term of the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes 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 (as defined in paragraph 5(c)) 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. 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 (as defined in para-

graph 5(k)). A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate (as defined in paragraph 5(1)), unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) 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.

8. 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 7(a) as appropriate under paragraph 6(b)(i). Otherwise, if the lease at inception meets any one of the four criteria in paragraph 7 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 6(b). If the lease does not meet any of the criteria of paragraph 7 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.
- b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.<sup>10b</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 such as insurance, maintenance, and taxes to be paid by the lessor (see paragraphs 17(a) and 18(a)) shall not by itself constitute an important uncertainty as referred to herein.

9. 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 7 and 8 had the

<sup>10a</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.

<sup>10b</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 criterion of paragraph 8(b) shall be applied at the date that construction of the property is completed or the property is acquired by the lessor.

## *Accounting for Leases*

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 7 and 8 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs 12 and 17(e), any action that extends the lease beyond the expiration of the existing lease term (see paragraph 5(f)), 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 6–8. 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.

### **Accounting and Reporting by Lessees**

#### ***Capital Leases***

10. The lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, together with any profit thereon. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value.<sup>10c</sup> If the portion of the minimum lease payments representing executory costs, including profit thereon, is not determinable from the provisions of the lease, an estimate of the amount shall be made. The discount rate to be used in determining present value of the minimum lease payments shall be that prescribed for the lessee in paragraph 7(d). (See Appendix C for illustrations.)

11. Except as provided in paragraphs 25 and 26 with respect to leases involving land, the asset recorded under a capital lease shall be amortized as follows:

- a. If the lease meets the criterion of either paragraph 7(a) or 7(b), the asset shall be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets.
- b. If the lease does not meet either criterion 7(a) or 7(b), the asset shall be amortized in a manner consistent with the lessee's normal depreciation policy except that the period of amortization shall be the lease term. The asset shall be amortized to its expected value, if any, to the lessee at the end of the lease term. As an example, if the lessee guarantees a residual value at the end of the lease term and has no interest in any excess which might be realized, the expected value of the leased property to him is the amount that can be realized from it up to the amount of the guarantee.

12. During the lease term, each minimum lease payment shall be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation.<sup>11</sup> (See Appendix C for illustrations.) In leases containing a residual guarantee by the lessee or a penalty for failure to renew the lease at the end of the lease term,<sup>12</sup> following the above method of amortization will result in a balance of the obligation 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 or a new lease under which the lessee continues to lease the same property renders the guarantee or penalty inoperative, the asset and the obligation under the lease shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised agreement shall be computed using the rate of interest used to record the lease initially. In accordance with paragraph 9, other renewals and extensions of the lease term shall be considered new agreements, which shall be accounted for in accordance with the provisions of

<sup>10c</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 pre-acquisition period, the effect of any increases that have occurred shall be considered in the determination of "fair value of the leased property at the inception of the lease" for purposes of this paragraph.

<sup>11</sup>This is the "interest" method described in the first sentence of paragraph 15 of *APB Opinion No. 21*, "Interest on Receivables and Payables," and in paragraphs 16 and 17 of *APB Opinion No. 12*, "Omnibus Opinion—1967."

<sup>12</sup>Residual guarantees and termination penalties that serve to extend the lease term (as defined in paragraph 5(f)) are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph.



paragraph 14. Contingent rentals shall be included in the determination of income as accruable.

13. Assets recorded under capital leases and the accumulated amortization thereon shall be separately identified in the lessee's balance sheet or in footnotes thereto. Likewise, the related obligations shall be separately identified in the balance sheet as obligations under capital leases and shall be subject to the same considerations as other obligations in classifying them with current and noncurrent liabilities in classified balance sheets. Unless the charge to income resulting from amortization of assets recorded under capital leases is included with depreciation expense and the fact that it is so included is disclosed, the amortization charge shall be separately disclosed in the financial statements or footnotes thereto.

14. 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 capital lease (see *FASB Statement No. 22*), a change in the provisions of a lease, a renewal or extension<sup>14</sup> of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:

- a. If the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (i) does not give rise to a new agreement under the provisions of paragraph 9 or (ii) does give rise to a new agreement but such agreement is also classified as a capital lease, the present balances of the asset and the obligation shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised or new agreement shall be computed using the rate of interest used to record the lease initially. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the transaction shall be accounted for under the sale-leaseback require-

ments of FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; and Initial Direct Costs of Direct Financing Leases*, or paragraphs 2 and 3 of FASB Statement No. 28, *Accounting for Sales with Leasebacks*, as applicable.

- b. Except when a guarantee or penalty is rendered inoperative as described in paragraph 12, a renewal or an extension<sup>15</sup> of an existing lease shall be accounted for as follows:
  - i. If the renewal or extension is classified as a capital lease, it shall be accounted for as described in subparagraph (a) above.
  - ii. If the renewal or extension is classified as an operating lease, the existing lease shall continue to be accounted for as a capital lease to the end of its original term, and the renewal or extension shall be accounted for as any other operating lease.
- c. A termination of a capital lease shall be accounted for by removing the asset and obligation, with gain or loss recognized for the difference.

### ***Operating Leases***

15. 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, 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.

### ***Disclosures***

16. The following information with respect to leases shall be disclosed in the lessee's financial statements or the footnotes thereto (see Appendix D for illustrations).

- a. For capital leases:
  - i. The gross amount of assets recorded under capital leases as of the date of each balance sheet presented by major classes according to nature or function. This information may be combined with the comparable information for owned assets.

<sup>13</sup>[This footnote has been deleted. See Status page.]

<sup>14</sup>See footnote 9.

<sup>15</sup>See footnote 9.

## *Accounting for Leases*

- ii. 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, with separate deductions from the total for the amount representing executory costs, including any profit thereon, included in the minimum lease payments and for the amount of the imputed interest necessary to reduce the net minimum lease payments to present value (see paragraph 10).
- iii. The total of minimum sublease rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.
- iv. Total contingent rentals actually incurred for each period for which an income statement is presented.
- b. For operating leases having initial or remaining noncancelable lease terms in excess of one year:
  - i. 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.
  - ii. 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 lessee's leasing arrangements including, but not limited to, the following:
  - i. The basis on which contingent rental payments are determined.
  - ii. The existence and terms of renewal or purchase options and escalation clauses.
  - iii. Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

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

#### ***Sales-Type Leases***

17. 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 such as maintenance, taxes, and insurance to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value (as defined in paragraph 5(i)) accruing to the benefit of the lessor shall be recorded as the gross investment in the lease. 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 except as provided in footnote 15a.<sup>15a</sup> However, if the sales-type lease involves real estate, the lessor shall account for the transaction under the provisions of *FASB Statement No. 66*, "Accounting for Sales of Real Estate," in the same manner as a *seller* of the same property.
- 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>16</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. Contingent rentals shall be included in the determination of income as accruable.

<sup>15a</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 pre-acquisition 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.

<sup>16</sup>See footnote 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 (as defined in paragraph 5(m)), 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. 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.
- 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<sup>18</sup> 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.
- 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 (see *FASB Statement No. 22*), a change in the provisions of a lease, a renewal or extension<sup>19</sup> of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:
- i. 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 9 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.
  - ii. Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension<sup>20</sup> 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)(i) 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.
    - c. If a renewal or extension that occurs at or near the end of the term<sup>20a</sup> of the existing lease is classified as a sales-type lease, the

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<sup>17</sup>See footnote 12.

<sup>18</sup>See footnote 9.

<sup>19</sup>See footnote 9.

<sup>20</sup>See footnote 9.

<sup>20a</sup>See footnote 9a.

## *Accounting for Leases*

- renewal or extension shall be accounted for as a sales-type lease.
- iii. 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.

### ***Direct Financing Leases***

18. Direct financing leases shall be accounted for by the lessor as follows (see Appendix C for illustrations):

- a. The sum of (i) the minimum lease payments (net of amounts, if any, included therein with respect to executory costs, such as maintenance, taxes, and insurance, to be paid by the lessor, together with any profit thereon) and (ii) the unguaranteed residual value accruing to the benefit of the lessor shall be recorded as the gross investment in the lease. 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>20b</sup>
- b. The difference between the gross investment in the lease in (a) above and the cost or carrying amount, if different, of the leased property shall be recorded as unearned income. The net investment in the lease shall consist of the gross investment plus any unamortized initial direct costs less the unearned income. The unearned income and initial direct costs 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>21</sup> However, other methods of income recognition may be used if the results obtained are not materially different from those that would result from the prescribed method in the preceding sentence. 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. Contingent rentals shall be included in the determination of income as accruable.

- c. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,<sup>22</sup> the lessor shall follow the accounting procedure described in paragraph 17 (e). The accounting provisions of paragraph 17(f) with respect to renewals and extensions not dealt with in paragraph 17(e), terminations, and other changes in lease provisions shall also be followed with respect to direct financing leases.
- d. The estimated residual value shall be reviewed at least annually and, if necessary, adjusted in the manner prescribed in paragraph 17(d).

### ***Operating Leases***

19. 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, 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.
- 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.
- 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 7(a) is less than its cost or carrying

<sup>20b</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 pre-acquisition 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.

<sup>21</sup>See footnote 11.

<sup>22</sup>See footnote 12.



amount, if different, then a loss equal to that difference shall be recognized at the inception of the lease.

### ***Participation by Third Parties***

20. The sale or assignment of a lease or of property subject to a lease that was accounted for as a sales-type lease or direct financing lease shall not negate the original accounting treatment accorded the lease. Any transfer of minimum lease payments under, or residual values that are guaranteed at the inception of, a sales-type lease or direct financing lease shall be accounted for in accordance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. However, transfers of unguaranteed residual values and residual values that are guaranteed after the inception of the lease are not subject to the provisions of Statement 140.

21. 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 retains substantial risks of ownership in the leased property. A seller may by various arrangements assure recovery of the investment by the third-party purchaser in some operating lease transactions and thus retain substantial risks in connection with the property. For example, in the case of default by the lessee or termination of the lease, the arrangements may involve a formal or informal commitment by the seller to (a) acquire the lease or the property, (b) substitute an existing lease, or (c) secure a replacement lessee or a buyer for the property under a remarketing agreement. However, a remarketing agreement by itself shall not disqualify accounting for the transaction as a sale if the seller (a) will receive a reasonable fee commensurate with the effort involved at the time of securing a replacement lessee or buyer for the property and (b) is not required to give priority to the re-leasing or disposition of the property owned by the third-party purchaser over similar property owned or produced by the seller. (For example, a first-in, first-out remarketing arrangement is considered to be a priority.)

22. If a sale to a third party 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 is not to be recorded as a sale because of the provisions of paragraph 21 above, the transaction shall be accounted for as a borrowing. (Transactions

of these types are in effect collateralized borrowings.) The proceeds from the "sale" shall be recorded as an obligation on the books of the "seller." Until that obligation has been amortized under the procedure described herein, rental payments made by the lessee(s) under the operating lease or leases shall be recorded as revenue by the "seller," even if such rentals are paid directly to the third-party purchaser. A portion of each rental shall be recorded by the "seller" as interest expense, with the remainder to be recorded as a reduction of the obligation. The interest expense shall be calculated by application of a rate determined in accordance with the provisions of *APB Opinion No. 21*, "Interest on Receivables and Payables," paragraphs 13 and 14. The leased property shall be accounted for as prescribed in paragraph 19(a) for an operating lease, except that the term over which the asset is depreciated shall be limited to the estimated amortization period of the obligation. The sale or assignment by the lessor of lease payments due under an operating lease shall be accounted for as a borrowing as described above.

### ***Disclosures***

23. When leasing, exclusive of leveraged 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 or footnotes thereto (see Appendix D for illustrations):

- a. For sales-type and direct financing leases:
  - i. The components of the net investment in sales-type and direct financing leases as of the date of each balance sheet presented:
    - (a) Future minimum lease payments to be received, with separate deductions for (i) amounts representing executory costs, including any profit thereon, included in the minimum lease payments and (ii) the accumulated allowance for uncollectible minimum lease payments receivable.
    - (b) The unguaranteed residual values accruing to the benefit of the lessor.
    - (c) For direct financing leases only, initial direct costs (see paragraph 5(m)).
    - (d) Unearned income (see paragraphs 17(b) and 18(b)).
  - ii. Future minimum lease payments to be received for each of the five succeeding fiscal years as of the date of the latest balance sheet presented.



## *Accounting for Leases*

- iii. [This subparagraph has been deleted. See Status page.]
- iv. Total contingent rentals included in income for each period for which an income statement is presented.
- b. For operating leases:
  - i. 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.
  - ii. 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 fiscal years.
  - iii. Total contingent rentals included in income for each period for which an income statement is presented.
- c. A general description of the lessor's leasing arrangements.

### **Leases Involving Real Estate**

24. For purposes of this Statement, leases involving real estate can be divided into four categories: (a) leases involving land only, (b) leases involving land and building(s), (c) leases involving equipment as well as real estate, and (d) leases involving only part of a building.

### ***Leases Involving Land Only***

25. If land is the sole item of property leased and the criterion in either paragraph 7(a) or 7(b) is met, the lessee shall account for the lease as a capital lease, otherwise, as an operating lease. If the lease gives rise to manufacturer's or dealer's profit (or loss) and the criterion of paragraph 7(a) is met, the lessor shall classify the lease as a sales-type lease as appropriate under paragraph 6(b)(i) and account for the transaction under the provisions of Statement 66 in the same manner as a *seller* of the same property. If the lease does not give rise to manufacturer's or dealer's profit (or loss) and the criterion of paragraph 7(a) and both criteria of paragraph 8 are met, the lessor shall account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 6(b). If the criterion of paragraph 7(b) and both criteria of

paragraph 8 are met, the lessor shall account for the lease as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 6(b). If the lease does not meet the criteria of paragraph 8, the lessor shall account for the lease as an operating lease. Criteria 7(c) and 7(d) are not applicable to land leases. Because ownership of the land is expected to pass to the lessee if either criterion 7(a) or 7(b) is met, the asset recorded under the capital lease would not normally be amortized.

### ***Leases Involving Land and Building(s)***

26. Leases involving both land and building(s) shall be accounted for as follows:

- a. Lease meets either criterion 7(a) or 7(b):
  - i. Lessee's accounting: If either criterion (a) or (b) of paragraph 7 is met, the land and building shall be separately capitalized by the lessee. For this purpose, the present value of the minimum lease payments after deducting executory costs, including any profit thereon, shall be allocated between the two elements in proportion to their fair values at the inception of the lease.<sup>22a</sup> The building shall be amortized in accordance with the provisions of paragraph 11(a). As stated in paragraph 25, land capitalized under a lease that meets criterion (a) or (b) of paragraph 7 would not normally be amortized.
  - ii. Lessor's accounting if the lease meets criterion 7(a): If the lease gives rise to manufacturer's or dealer's profit (or loss), the lessor shall classify the lease as a sales-type lease as appropriate under paragraph 6(b)(i) and account for the lease as a single unit under the provisions of Statement 66 in the same manner as a *seller* of the same property. If the lease does not give rise to manufacturer's or dealer's profit (or loss) and meets both criteria of paragraph 8, the lessor shall account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 6(b)(ii) or 6(b)(iii). If the lease does not give rise to manufacturer's or dealer's profit (or loss) and does not meet both criteria of paragraph 8, the lessor shall account for the lease as an operating lease.

<sup>22a</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 pre-acquisition period, the effect of any increases that have occurred shall be considered in the determination of "fair value of the leased property at the inception of the lease" for purposes of this paragraph.

- iii. Lessor's accounting if the lease meets criterion 7(b): If the lease gives rise to manufacturer's or dealer's profit (or loss), the lessor shall classify the lease as an operating lease as appropriate under paragraph 6(b)(iv). If the lease does not give rise to manufacturer's or dealer's profit (or loss) and meets both criteria of paragraph 8, the lessor shall account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 6(b)(ii) or 6(b)(iii). If the lease does not give rise to manufacturer's or dealer's profit (or loss) and does not meet both criteria of paragraph 8, the lessor shall account for the lease as an operating lease.
- b. Lease meets neither criterion 7(a) nor 7(b):
  - i. If the fair value of the land is less than 25 percent of the total fair value of the leased property at the inception of the lease: Both the lessee and the lessor shall consider the land and the building as a single unit for purposes of applying the criteria of paragraphs 7(c) and 7(d). For purposes of applying the criterion of paragraph 7(c), the estimated economic life of the building shall be considered as the estimated economic life of the unit.
    - (a) Lessee's accounting: If either criterion (c) or (d) of paragraph 7 is met, the lessee shall capitalize the land and building as a single unit and amortize it in accordance with the provisions of paragraph 11(b); otherwise, the lease shall be accounted for as an operating lease.
    - (b) Lessor's accounting: If either criterion (c) or (d) of paragraph 7 and both criteria of paragraph 8 are met, the lessor shall account for the lease as a single unit as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 6(b). If the lease meets neither criterion (c) nor (d) of paragraph 7 or does not meet both criteria of paragraph 8, the lease shall be accounted for as an operating lease.
  - ii. If the fair value of the land is 25 percent or more of the total fair value of the leased property at the inception of the lease: Both the lessee and lessor shall consider the land and the building separately for purposes of applying the criteria of paragraphs 7(c) and 7(d). The minimum lease payments after deducting executory costs, including any profit thereon, applicable to the land and the building shall be separated both by the lessee and the lessor by determining the fair value of the land and applying the lessee's incremental borrowing rate to it to determine the annual minimum lease payments applicable to the land element; the remaining minimum lease payments shall be attributed to the building element.
    - (a) Lessee's accounting: If the building element of the lease meets criterion (c) or (d) of paragraph 7, the building element shall be accounted for as a capital lease and amortized in accordance with the provisions of paragraph 11(b). The land element of the lease shall be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 7, both the building element and the land element shall be accounted for as a single operating lease.
    - (b) Lessor's accounting: If the building element of the lease meets either criterion (c) or (d) of paragraph 7 and both criteria of paragraph 8, the building element shall be accounted for as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 6(b). The land element of the lease shall be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 7 or does not meet the criteria of paragraph 8, both the building element and the land element shall be accounted for as a single operating lease.

#### ***Leases Involving Equipment as Well as Real Estate***

27. If a lease involving real estate also includes equipment, the portion of the minimum lease payments applicable to the equipment element of the lease shall be estimated by whatever means are appropriate in the circumstances. The equipment shall be considered separately for purposes of applying the criteria in paragraphs 7 and 8 and shall be accounted for separately according to its classification by both lessees and lessors.

#### ***Leases Involving Only Part of a Building***

28. When the leased property is part of a larger whole, its cost (or carrying amount) and fair value may not be objectively determinable, as for example,

## *Accounting for Leases*

when an office or floor of a building is leased. If the cost and fair value of the leased property are objectively determinable, both the lessee and the lessor shall classify and account for the lease according to the provisions of paragraph 26. Unless both the cost and the fair value are objectively determinable, the lease shall be classified and accounted for as follows:

- a. Lessee:
  - i. If the fair value of the leased property is objectively determinable, the lessee shall classify and account for the lease according to the provisions of paragraph 26.
  - ii. If the fair value of the leased property is not objectively determinable, the lessee shall classify the lease according to the criterion of paragraph 7(c) only, using the estimated economic life of the building in which the leased premises are located. If that criterion is met, the leased property shall be capitalized as a unit and amortized in accordance with the provisions of paragraph 11(b).
- b. Lessor: If either the cost or the fair value of the property is not objectively determinable, the lessor shall account for the lease as an operating lease.

Because of special provisions normally present in leases involving terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for purposes of classifying the lease is essentially indeterminate. Likewise, the concept of fair value is not applicable to such leases. Since such leases also do not provide for a transfer of ownership or a bargain purchase option, they shall be classified as operating leases. Leases of other facilities owned by a governmental unit or authority wherein the rights of the parties are essentially the same as in a lease of airport facilities described above shall also be classified as operating leases. Examples of such leases may be those involving facilities at ports and bus terminals.

### **Leases between Related Parties**

29. Except as noted below, leases between related parties (as defined in paragraph 5(a)) shall be classified in accordance with the criteria in paragraphs 7 and 8. Insofar as the separate financial statements of

the related parties are concerned, the classification and accounting shall be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such cases the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties shall be disclosed.

30. In consolidated financial statements or in financial statements for which an interest in an investee is accounted for on the equity basis, any profit or loss on a leasing transaction with the related party shall be accounted for in accordance with the principles set forth in *ARB No. 51*, "Consolidated Financial Statements," or *APB Opinion No. 18*, whichever is applicable.

31. The accounts of subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to the parent or other affiliated companies shall be consolidated. The equity method is not adequate for fair presentation of those subsidiaries because their assets and liabilities are significant to the consolidated financial position of the enterprise.

### **Sale-Leaseback Transactions**

32. 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 33 and shall be accounted for by the purchaser-lessor in accordance with the provisions of paragraph 34.

33. If the lease meets one of the criteria for treatment as a capital lease (see paragraph 7), 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>22b</sup> shall be deferred and amortized in proportion to the amortization of the leased asset,<sup>23</sup> if a capital lease, or in proportion to the related gross rental

<sup>22b</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 FASB Statement No. 66, *Accounting for Sales of Real Estate*, 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 Statement No. 66.

<sup>23</sup>If the leased asset is land only, the amortization shall be on a straight-line basis over the lease term.

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>23a</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.
- b. The seller-lessee retains more than a minor part but less than substantially all<sup>23b</sup> of the use of the property through the leaseback and realizes a profit on the sale<sup>23c</sup> in excess of (i) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or (ii) 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 7(d).
- c. The fair value of the property at the time of the transaction is less than its undepreciated cost, in which case a loss shall be recognized immediately up to the amount of the difference between undepreciated cost and fair value.

34. If the lease meets the criteria in paragraphs 7 and 8, the purchaser-lessor shall record the transaction as a purchase and a direct financing lease; otherwise, he shall record the transaction as a purchase and an operating lease.

### Accounting and Reporting for Subleases and Similar Transactions

35. This section deals with the following types of leasing transactions:

- a. The leased property is re-leased by the original lessee to a third party, and the lease agreement between the two original parties remains in effect (a sublease).
- b. A new lessee is substituted under the original lease agreement. The new lessee becomes the primary obligor under the agreement, and the original lessee may or may not be secondarily liable.
- c. A new lessee is substituted through a new agreement, with cancellation of the original lease agreement.

#### Accounting by the Original Lessor

36. If the original lessee enters into a sublease or the original lease agreement is sold or transferred by the original lessee to a third party, the original lessor shall continue to account for the lease as before.

37. If the original lease agreement is replaced by a new agreement with a new lessee, the lessor shall account for the termination of the original lease as provided in paragraph 17(f) and shall classify and account for the new lease as a separate transaction.

#### Accounting by the Original Lessee

38. If the nature of the transaction is such that the original lessee is relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraphs 35(b) and 35(c), the termination of the original lease agreement shall be accounted for as follows:

- a. If the original lease was a capital lease of property other than real estate (including integral equipment), the asset and obligation representing the original lease shall be removed from the accounts, a gain or loss shall be recognized for the

<sup>23a</sup> "Substantially all" and "minor" are used here in the context of the concepts underlying the classification criteria of *FASB Statement No. 13*. In that context, a test based on the 90 percent recovery criterion of Statement No. 13 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 purchaser-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.

<sup>23b</sup> "Substantially all" is used here in the context of the concepts underlying the classification criteria of *FASB Statement No. 13*. In that context, if a leaseback of the *entire property sold* meets the criteria of Statement No. 13 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.

<sup>23c</sup> See footnote 22b.



## *Accounting for Leases*

- difference, and, if the original lessee is secondarily liable, the guarantee obligation shall be recognized in accordance with paragraph 114 of Statement 140. Any consideration paid or received upon termination shall be included in the determination of gain or loss to be recognized.
- b. If the original lease was a capital lease of real estate (including integral equipment), the determination as to whether the asset held under the capital lease and the related obligation may be removed from the balance sheet shall be made in accordance with the requirements of Statement 66. If the criteria for recognition of a sale in Statement 66 are met, the asset and obligation representing the original lease shall be removed from the accounts and any consideration paid or received upon termination and any guarantee obligation shall be recognized in accordance with the requirements above for property other than real estate. If the transaction results in a gain, that gain may be recognized if the criteria in Statement 66 for recognition of profit by the full accrual method are met. Otherwise, the gain shall be recognized in accordance with one of the other profit recognition methods discussed in Statement 66. Any loss on the transaction shall be recognized immediately.
  - c. If the original lease was an operating lease and the original lessee is secondarily liable, the guarantee obligation shall be recognized in accordance with paragraph 114 of Statement 140.
39. If the nature of the transaction is such that the original lessee is not relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraph 35(a), the original lessee, as sublessor, shall account for the transaction as follows:
- a. If the original lease met either criterion (a) or (b) of paragraph 7, the original lessee shall classify the new lease in accordance with the criteria of paragraphs 7 and 8. If the new lease meets one of the criteria of paragraph 7 and both of the criteria of paragraph 8, it shall be accounted for as a sales-type or direct financing lease, as appropriate, and the unamortized balance of the asset under the original lease shall be treated as the cost of the leased property. If the new lease does not qualify as a sales-type or direct financing lease, it shall be accounted for as an operating lease. In either case, the original lessee shall continue to account for the obligation related to the original lease as before.
  - b. If the original lease met either criterion (c) or (d) but not criterion (a) or (b) of paragraph 7, the original lessee shall, with one exception, classify the new lease in accordance with the criteria of paragraphs 7(c) and 8 only. If it meets those criteria, it shall be accounted for as a direct financing lease, with the unamortized balance of the asset under the original lease treated as the cost of the leased property; otherwise, as an operating lease. In either case, the original lessee shall continue to account for the obligation related to the original lease as before. The one exception arises when the timing and other circumstances surrounding the sublease are such as to suggest that the sublease was intended as an integral part of an overall transaction in which the original lessee serves only as an intermediary. In that case, the sublease shall be classified according to the criteria of paragraphs 7(c) and 7(d), as well as the criteria of paragraph 8. In applying the criterion of paragraph 7(d), the fair value of the leased property shall be the fair value to the original lessor at the inception of the original lease.
  - c. If the original lease is an operating lease, the original lessee shall account for both it and the new lease as operating leases.

### *Accounting by the New Lessee*

40. The new lessee shall classify the lease in accordance with the criteria of paragraph 7 and account for it accordingly.

### **Accounting and Reporting for Leveraged Leases**

41. From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as non-leveraged leases. The balance of this section deals with leveraged leases from the standpoint of the lessor.
42. For purposes of this Statement, a leveraged lease is defined as one having all of the following characteristics:
- a. Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph 6(b)(ii), it otherwise meets that definition. Leases that meet the definition of sales-type leases set forth in paragraph 6(b)(i) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph 17.
  - b. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the 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 the financing is sufficient to provide the lessor with substantial "leverage" in the transaction.
- d. The lessor's net investment, as defined in paragraph 43, 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 described in paragraphs 43-47; an exception arises if the investment tax credit is accounted for other than as stated in paragraphs 43 and 44,<sup>24</sup> in which case the lease shall be classified as a direct financing lease and accounted for in accordance with paragraph 18. A lease not meeting the definition of a leveraged lease shall be accounted for in accordance with its classification under paragraph 6(b)

43. The lessor shall record his investment in a leveraged lease net of the nonrecourse debt. 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 the investment tax credit to be realized on the transaction.
- c. The estimated residual value of the leased asset. The estimated residual value shall not exceed the amount estimated at the inception of the lease except as provided in footnote 24a.<sup>24a</sup>
- d. Unearned and deferred income consisting of
  - (i) the estimated pretax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income over the lease term and
  - (ii) the investment tax credit remaining to be allocated to income over the lease term.

The investment in leveraged leases less deferred taxes arising from differences between 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 44.

44. 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>25</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 (see Appendix E, Schedule 3) and is distinct from the interest rate implicit in the lease as defined in paragraph 5(k). 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 43; 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 43 and in this paragraph is illustrated in Appendix E.

45. If the projected net cash receipts<sup>26</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 43 and 44 would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in

<sup>24</sup>It is recognized that the investment tax credit may be accounted for other than as prescribed in this Statement, as provided by Congress in the Revenue Act of 1971.

<sup>24a</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 pre-acquisition 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.

<sup>25</sup>The use of the term "years" is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods.

<sup>26</sup>For purposes of this paragraph, net cash receipts shall be gross cash receipts less gross cash disbursements exclusive of the lessor's initial investment.

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cases where one of the important assumptions affecting net income is revised (see paragraph 46).

46. Any estimated residual value and all other important assumptions affecting estimated total net income from the lease shall be reviewed at least annually. The projected timing of income tax cash flows generated by the lease is an important assumption and shall be reviewed annually, or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. If during the lease term (a) 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, (b) the revision of another important assumption changes the estimated total net income from the lease, or (c) the projected timing of the income tax cash flows is revised, 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 44 and using the revised assumption. The lessor shall update all assumptions used to calculate total and periodic income when the lessor is performing a recalculation of the leveraged lease. The recalculation shall include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation. If the lessor expects to enter into a settlement with a taxing authority, the cash flows following the date of recalculation shall include projected cash flows between the date of the recalculation and the date of any projected settlement and a projected settlement amount at the date of the projected settlement. The recalculation shall not include interest or penalties in the cash flows from the leveraged lease. Advance payments and deposits made with a taxing authority shall not be considered an actual cash flow of the leveraged lease; rather, those payments and deposits shall be included in the projected settlement amount. 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. The pretax gain or loss recognized shall be included in income from continuing operations before income taxes in the same line item in which leveraged lease income is recognized. The tax effect of the recognized gain or loss shall be included in the income tax line item. An upward adjustment of the estimated residual value shall not be made. The accounting prescribed in this paragraph is illustrated in Appendix E.

46A. The following illustrates how a lessor would include advance payments and deposits in a recal-

ulation of a leveraged lease. A lessor makes an advance payment of \$25 on July 1, 2007, \$10 of which is estimated to be associated with issues arising from a Lease In-Lease Out (LILO) transaction. On July 1, 2007, the lessor changes its assumption about the timing of the tax cash flows and projects a settlement with the Internal Revenue Service on September 1, 2009. The projected settlement would result in a payment to the taxing authority of \$125 of which \$50 is associated with the LILO transaction. On July 1, 2007, when the lessor recalculates the leveraged lease, the lessor would include a \$50 cash flow on September 1, 2009, as a projected outflow in the leveraged lease recalculation. The example assumes that the lessor has concluded that the position originally taken on the tax return would meet the more-likely-than-not threshold in FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. It also assumes that the lessor would conclude that the estimate of \$50 for the projected LILO settlement is consistent with the measurement guidance in Interpretation 48.

46B. A revision of the projected timing of the income tax cash flows applies only to changes or projected changes in the timing of income taxes that are directly related to the leveraged lease transaction. For example, a change in timing as a result of (a) an interpretation of the tax law, (b) a change in the lessor's assessment of the likelihood of prevailing in a challenge by the taxing authority, or (c) a change in the lessor's expectations about settlement with the taxing authority that will change the timing or projected timing of the tax benefits generated by a leveraged lease would require a recalculation because that change in timing is directly related to that lease. However, a change in timing of income taxes solely as a result of an alternative minimum tax credit or insufficient taxable income of the lessor would not require a recalculation of a leveraged lease because that change in timing is not directly related to that lease. This position is consistent with Issue 10 of EITF Issue No. 87-8, "Tax Reform Act of 1986: Issues Related to the Alternative Minimum Tax." FASB Staff Position FAS 13-2, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction," does not change the conclusion in Issue 87-8 that a recalculation would not be required unless there is an indication that the previous assumptions about total after-tax net income from the lease were no longer valid.

46C. Tax positions shall be reflected in the lessor's initial calculation and/or subsequent recalculation



based on the recognition, derecognition, and measurement criteria in Interpretation 48. The determination of when a tax position no longer meets the recognition, derecognition, and measurement provisions of Interpretation 48 is a matter of individual facts and circumstances evaluated in light of all available evidence.

47. 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 43 shall be disclosed in the footnotes to the financial statements. Appendix E contains an illustration of the balance sheet, income statement, and footnote presentation for a leveraged lease.

#### Effective Date and Transition

48. The preceding paragraphs of this Statement shall be effective for leasing transactions and lease agreement revisions (see paragraph 9) entered into on or after January 1, 1977. However, leasing transactions or revisions of agreements consummated on or after January 1, 1977 pursuant to the terms of a commitment made prior to that date and renewal options exercised under agreements existing or committed prior to that date shall not be considered as leasing transactions or lease agreement revisions entered into after January 1, 1977 if such commitment is in writing, signed by the parties in interest to the transaction, including the financing party,<sup>27</sup> if any, when specific financing is essential to the transaction, and specifically sets forth the principal terms of the transaction. The disclosures called for in the preceding paragraphs of this Statement shall be included in financial statements for calendar or fiscal years ending after December 31, 1976.<sup>28</sup> Earlier application of the preceding paragraphs of this Statement, including retroactive application to all leases regardless of when they were entered into or committed is encouraged

but, until the effective date specified in paragraph 49, is not required. If applied retroactively, financial statements presented for prior periods shall be restated according to the provisions of paragraph 51.

49. For purposes of financial statements for calendar or fiscal years beginning after December 31, 1980, paragraphs 1–47 of this Statement shall be applied retroactively, and any accompanying financial statements presented for prior periods shall be restated as may be required by the provisions of paragraph 51.

50. If paragraphs 1–47 are not applied initially on a retroactive basis, as permitted by paragraph 48, those leases existing or committed at December 31, 1976 shall be subject to the following provisions until such time as paragraphs 1–47 are applied retroactively to all leases.

- a. For purposes of applying the presentation and disclosure requirements of this Statement applicable to lessees, those leases existing or committed at December 31, 1976 that are capitalized in accordance with the provisions of superseded *APB Opinion No. 5* shall be considered as capital leases, and those leases existing or committed at December 31, 1976 that are classified and accounted for as operating leases shall be considered as operating leases. For those leases that are classified and accounted for as operating leases but that meet the criteria of paragraph 7 for classification as capital leases, separate disclosure of the following information shall be made for purposes of financial statements for the year ending December 31, 1977 and for years ending thereafter:
  - i. The amounts of the asset and the liability that would have been included in the balance sheet had those leases been classified and accounted for in accordance with the provisions of paragraphs 1–47. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the financial statements referred to in paragraph 50(a) above.
  - ii. The effect on net income that would have resulted if those leases had been classified and accounted for in accordance with the provisions of paragraphs 1–47. This information

<sup>27</sup>For purposes of this paragraph, the term "financing party" shall include an interim lender pending long-term financing.

<sup>28</sup>For an enterprise having a fiscal year of 52 or 53 weeks ending in the last seven days in December or the first seven days in January, references to December 31 in paragraphs 48–51 shall mean the date in December or January on which the fiscal year ends.



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shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.

- b. For purposes of applying the presentation and disclosure requirements of this Statement applicable to lessors, those leases existing or committed at December 31, 1976 that are accounted for as sales, financing leases, and as operating leases in accordance with superseded *APB Opinions No. 7* and *27* shall be considered as sales-type leases, as direct financing leases, and as operating leases, respectively. (Refer to (c) below for provisions applicable to leveraged leases.) For those leases existing or committed at December 31, 1976 that are classified and accounted for as operating leases but that meet the criteria of paragraphs 7 and 8 for classification as direct financing leases or sales-type leases, separate disclosure of the following information shall be made for purposes of financial statements for the year ending December 31, 1977 and for years ending thereafter:
    - i. The amount of the change in net worth that would have resulted had the leases been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the foregoing financial statements referred to in paragraph 50(b) above.
    - ii. The effect on net income that would have resulted if the leases had been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.
  - c. For those leases that meet the criteria of paragraph 42 (leveraged leases) but that are accounted for other than as prescribed in paragraphs 1-47, separate disclosure of the following information shall be made for purposes of lessors' financial statements for the year ending December 31, 1977 and for years ending thereafter:
    - i. The amounts of the net changes in total assets and in total liabilities that would have resulted had the leases been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the financial statements referred to in paragraph 50(c) above.
    - ii. The effect on net income that would have resulted if the leases had been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.
51. Paragraph 49 requires retroactive application of paragraphs 1-47 for purposes of financial statements for calendar or fiscal years beginning after December 31, 1980, and paragraph 48 encourages earlier retroactive application. If after retroactive application is adopted, financial statements for earlier periods and financial summaries or other data derived from them are presented, they shall be restated in accordance with the following requirements to conform to the provisions of paragraphs 1-47:
- a. Such restatements shall include the effects of leases that were in existence during the periods covered by the financial statements even if those leases are no longer in existence.
  - b. Balance sheets presented as of December 31, 1976 and thereafter and income statements presented for periods beginning after December 31, 1976 and financial summaries and other data derived from those financial statements shall be restated to conform to the provisions of paragraphs 1-47.
  - c. Balance sheets as of dates before December 31, 1976 and income statements for periods beginning before December 31, 1976 shall, when presented, be restated to conform to the provisions of paragraphs 1-47 for as many consecutive periods immediately preceding December 31, 1976 as is practicable. Summaries or other data presented based on such balance sheets and income statements shall be treated in like manner.
  - d. The cumulative effect of applying paragraphs 1-47 on the retained earnings at the beginning of the earliest period restated shall be included in determining net income of that period

(see paragraph 20 of *APB Opinion No. 20*, "Accounting Changes").<sup>29</sup> The effect on net income of applying paragraphs 1–47 in the period in which the cumulative effect is included in deter-

mining net income shall be disclosed for that period, and the reason for not restating the prior periods presented shall be explained.

**The provisions of this Statement need not be applied to immaterial items.**

*This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Mr. Kirk dissented.*

Mr. Kirk dissents primarily because he does not believe that the front-ending of lease income required by paragraph 44 for leveraged leases versus the method of lease income recognition required by paragraph 18(b) for direct financing leases is justified by any significant economic (i.e., cash flow) differences between the two types of leases. The front-ending of leveraged lease income results from treating the related debt and deferred tax benefits (principally the latter) as valuation accounts, and Mr. Kirk believes that the treatment as valuation accounts is unwarranted.

The leasing business is a leveraged business. Many leases are partially financed by recourse debt; some leases are partially financed by nonrecourse debt. Mr. Kirk believes the cash inflows from the lessee and the outflows to the creditor can be similar whether the debt is recourse or nonrecourse, and he does not believe that a difference in the method of financing a lease should be a factor in determining the pattern of recognizing lease income (and interest expense) as is required by this Statement. Mr. Kirk also objects to the inconsistent classification of nonrecourse debt required by this Statement (i.e., if the lease meets the criteria of paragraph 42, the nonrecourse debt financing the lease is a valuation account and *not* a liability; if the lessor is the manufacturer of the leased asset or if the lease does not meet all the criteria of paragraph 42, the nonrecourse debt is a liability).

The amount and timing of the cash flow benefits resulting from the tax attributes of a leased asset are the same to the lessor whether he finances the asset with recourse debt, with nonrecourse debt, or with equity. A difference in the method of financing the lease should not, in the opinion of Mr. Kirk, result in a difference in accounting for deferred taxes. This

Statement, however, requires that deferred income tax balances arising from tax timing differences be accounted for as a valuation account (for purposes of computing periodic lease income) only if (a) the lease is financed with *substantial* nonrecourse debt and (b) the lessor accounts for the benefit from the investment tax credit as a valuation account. The special treatment of these deferred tax benefits as valuation accounts results in a net investment that declines in the early years and rises during the later years; that result then requires the front-ending of lease income. Also, Mr. Kirk can see no reason why the method of accounting for the investment tax credit should determine the accounting for deferred income taxes and, therefore, the pattern of lease income recognition.

Mr. Kirk also believes the treatment of deferred taxes and the required method of accounting for changes in assumptions (paragraph 46) result in the deferred taxes related to leveraged leases being accounted for by the *liability method*, which is not in conformity with the requirements of *APB Opinion No. 11*, "Accounting for Income Taxes," and the accounting for deferred taxes related to other leases.

In order to avoid having (a) the method of financing, (b) the debt repayment schedule, and (c) the method of accounting for deferred tax benefits influence the pattern of recognition of lease income, interest expense, and initial direct costs (as is the case for those leases meeting the criteria of paragraph 42), Mr. Kirk believes it is necessary to use the ordinary financing lease method (paragraph 109(a)) for all financing leases, including those financed with nonrecourse debt. However, in view of the present inconsistencies in accounting for nonrecourse debt, Mr. Kirk would not have dissented to a requirement that the three-party financing lease method (paragraph 109(b)) be used for financing leases financed

<sup>29</sup>Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* are not applicable.

## *Accounting for Leases*

with nonrecourse debt. Both methods avoid the inconsistent treatment of nonrecourse debt and the front-ending of lease income.

Mr. Kirk also dissents because he objects to the exemption in paragraph 28 that applies to certain facilities leased from governmental units because of spe-

cial provisions *normally* present in those leases. Mr. Kirk believes the classification of all leases, regardless of the nature of the asset or lessor, should be determined by application of the criteria in paragraphs 7 and 8.

### *Members of the Financial Accounting Standards Board:*

Marshall S. Armstrong,  
*Chairman*  
Oscar S. Gellein

Donald J. Kirk  
Arthur L. Litke

Robert E. Mays  
Robert T. Sprouse

## **Appendix A**

### **BACKGROUND INFORMATION**

52. The growing importance of leasing as a financing device was recognized by the accounting profession as early as 1949, when the AI[CPA] issued *Accounting Research Bulletin No. 38*, "Disclosure of Long-Term Leases in Financial Statements of Lessees." In early 1960, the newly formed APB recognized the importance of the matter by including lease accounting as one of the first five topics to be studied by the AICPA's Accounting Research Division. That project culminated in 1962 with the publication of *Accounting Research Study No. 4*, "Reporting of Leases in Financial Statements," and shortly thereafter the APB took up the subject. In all, during the ten years ending June 30, 1973, the APB issued four Opinions (No. 5, 7, 27, and 31) dealing with leases. They were supplemented by three AICPA Accounting Interpretations. The last of the APB Opinions, *APB Opinion No. 31*, "Disclosure of Lease Commitments by Lessees," as its name implies, dealt only with disclosure. The APB had previously acknowledged that certain questions remained in connection with Opinions 5 and 7 and had publicly announced its intention to give those questions further consideration. The APB decided, however, to deal only with additional disclosure requirements. In paragraph 5 of *APB Opinion No. 31*, which was approved in June 1973, the APB noted that:

... disclosure of lease commitments is part of the broad subject of accounting for leases

by lessees, a subject which has now been placed on the agenda of the Financial Accounting Standards Board. The Board [APB] also recognizes that the forthcoming report of the Study Group on the Objectives of Financial Statements may contain recommendations which will bear on this subject and which the FASB may consider in its deliberations. Accordingly, the Board is refraining from establishing any disclosure requirements which may prejudice or imply any bias with respect to the outcome of the FASB's undertaking, particularly in relation to the questions of which leases, if any, should be capitalized and how such capitalization may influence the income statement. Nevertheless, in the meantime the Board recognizes the need to improve the disclosure of lease commitments in order that users of financial statements may be better informed.

53. The SEC, too, has issued a number of pronouncements on accounting for leases, including three Accounting Series Releases: No. 132, 141, and 147, adopted on October 5, 1973. The latter Release imposes essentially the same disclosure requirements with respect to total rental expense and minimum rental commitments as *APB Opinion No. 31*. However, it makes mandatory the disclosure of the present value of certain lease commitments (defined differently from the optional present value disclosure included in *APB Opinion No. 31*). In addition, it requires disclosure of the impact on net income had "financing" leases been capitalized, a disclosure not called for by *APB Opinion No. 31*.

54. Despite the attention that the accounting profession has given to the matter of accounting for leases, inconsistencies remain in lease accounting practices, and differences of opinion as to what should be done about them remain. In recognition of that fact, the FASB placed on its initial agenda a project on Accounting for Leases. In October 1973, a task force of 11 persons from industry, government, public accounting, the financial community, and academe was appointed to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

55. As indicated above, accounting for leases is a subject which has been thoroughly studied over a long period of time and on which numerous pronouncements have been made. Extensive research has been carried out; several public hearings have been held for which position papers were filed by many interested parties and groups; especially appointed committees, not only of the Accounting Principles Board, but of a number of other organizations, have analyzed and debated the issues. A considerable number of the studies and articles on lease accounting were available to the Board, many of which are summarized or identified in the Discussion Memorandum. In addition, the FASB staff surveyed the accounting and reporting practices of a number of lessee and lessor companies, the results of which are set forth in Appendix C to the Discussion Memorandum. The staff also met on a number of occasions with representatives of various organizations interested in leasing for the purpose of obtaining specialized information helpful to the Board's consideration of the various issues involved in accounting for leases.

56. The Board issued its Discussion Memorandum on July 2, 1974, and on November 18–21, 1974 held a public hearing on the subject. The Board received 306 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum, and 32 presentations were made at the public hearing.

57. On August 26, 1975, the Financial Accounting Standards Board issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards on Accounting for Leases that, if adopted, would have been effective for leasing transactions entered into on or after January 1, 1976. Two hundred and fifty letters of comment were received in response to that Exposure Draft. The Board announced on November 25, 1975 that, because of the need to analyze the large number of responses and the complexity of

the issues involved, it would be unable to issue a final Statement in 1975 but expected to do so early in 1976. A further announcement made by the Board on June 2, 1976 stated that a number of modifications were being made to the Exposure Draft and that a second Exposure Draft would be issued for public comment preparatory to the expected issuance of a final Statement in 1976.

58. The Board issued the second Exposure Draft of a Proposed Statement of Financial Accounting Standards on Accounting for Leases on July 22, 1976. Two hundred and eighty-two letters of comment were received in response to that Exposure Draft.

## Appendix B

### BASIS FOR CONCLUSIONS

59. This Appendix discusses factors deemed significant by the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

60. The provisions of this Statement derive from the view 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. This is not to say, however, that such transactions are necessarily "in substance purchases" as that term is used in previous authoritative literature.

61. The transfer of substantially all the benefits and risks of ownership is the concept embodied in previous practice in lessors' accounting, having been articulated in both *APB Opinion No. 7*, "Accounting for Leases in Financial Statements of Lessors," and *APB Opinion No. 27*, "Accounting for Lease Transactions by Manufacturer or Dealer Lessors," as a basis for determining whether a lease should be accounted for as a financing or sale or as an operating lease. However, a different concept has existed in the authoritative literature for lessees' accounting, as evidenced by *APB Opinion No. 5*, "Reporting of Leases in Financial Statements of Lessee." That Opinion required capitalization of those leases that are "clearly



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in substance installment purchases of property,” which it essentially defined as those leases whose terms “result in the creation of a material equity in the property.” Because of this divergence in both concept and criteria, a particular leasing transaction might be recorded as a sale or as a financing by the lessor and as an operating lease by the lessee. This difference in treatment has been the subject of criticism as being inconsistent conceptually, and some of the identifying criteria for classifying leases, particularly those applying to lessees’ accounting, have been termed vague and subject to varied interpretation in practice.

62. The Board believes that this Statement removes most, if not all, of the conceptual differences in lease classification as between lessors and lessees and that it provides criteria for such classification that are more explicit and less susceptible to varied interpretation than those in previous literature.

63. Some members of the Board who support this Statement hold the view that, regardless of whether substantially all the benefits and risks of ownership are transferred, a lease, in transferring for its term the right to use property, gives rise to the acquisition of an asset and the incurrence of an obligation by the lessee which should be reflected in his financial statements. Those members nonetheless support this Statement because, to them, (i) it clarifies and improves the guidelines for implementing the conceptual basis previously underlying accounting for leases and (ii) it represents an advance in extending the recognition of the essential nature of leases.

### Definition of a Lease

64. Some respondents took the position that nuclear fuel leases, sometimes called “heat supply” or “burn up” contracts, should be excluded from the definition of a lease on the grounds that such agreements are of the same nature as take-or-pay contracts to supply other types of fuel such as coal or oil which are excluded. The Board’s conclusion that nuclear fuel leases meet the definition of a lease as expressed in paragraph 1 is based on the fact that under present generally accepted accounting principles a nuclear fuel installation constitutes a depreciable asset. Thus, a nuclear fuel lease conveys the right to use a depreciable asset whereas contracts to supply coal or oil do not. The fact that the latter contracts may be take-or-pay, in the Board’s view, is irrelevant to this central point.

### Classification of Leases

65. The Board believes that the characteristics of a leasing transaction should determine its classification in terms of the appropriate accounting treatment by both the lessee and lessor; this is to say that the characteristics that identify a lease as a capital lease, as distinct from an operating lease, from the standpoint of the lessee should, with certain exceptions identified in this Statement, be the same attributes that identify a direct financing or sales-type lease, as distinct from an operating lease, from the standpoint of the lessor. The principal exceptions referred to are those stated in paragraph 8.

66. The Board considered and rejected, for the reason set forth in paragraph 65, the argument that the difference in the nature of the lessor’s and lessee’s businesses is often sufficient to warrant different classification of a lease by the two parties.

67. Some respondents to the Discussion Memorandum and Exposure Drafts, while agreeing generally with the premise that the nature of the transaction should govern its classification by both the lessee and lessor, pointed out that there is no assurance that the transaction will be discerned identically by both parties. However, the Board believes that by adopting essentially the same criteria for classification of leases by both parties (see paragraph 65), as contrasted with the difference in criteria previously existing between *APB Opinion No. 5*, concerning lessee accounting, and *APB Opinions No. 7 and 27*, concerning lessor accounting, and, by virtue of the fact that the criteria adopted are in some respects more explicit than those referred to in those Opinions, that a significant improvement in consistency of classification can be achieved.

68. A large number of respondents favored capitalization by lessees of only those leases that they would classify as “in substance installment purchases.” A wide range of preferences was expressed as to the criteria to be used to identify such leases. Most prominent among these was the “material equity” criterion that is the basic criterion of *APB Opinion No. 5* and that is discussed in paragraph 73. Most of those favoring this concept would apply it only to the lessee rather than to both parties.

69. The Board considered the concept for capitalization by the lessee of those leases that are “in substance installment purchases.” Such leases, if identifiable, would be encompassed within the concept

described in paragraph 60, but, by itself, the installment purchase concept, in the Board's view, is too limiting as a basis for lease capitalization. Taken literally, the concept would apply only to those leases that automatically transfer ownership. All other leases contain characteristics not found in installment purchases, such as the reversion of the property to the lessor at the termination of the lease.

70. Some respondents advocated capitalization of leases that give rise to what they term "debt in a strict legal sense." A number of the respondents in this group were also represented in the group referred to in paragraph 68, indicating that they view the two concepts as not being mutually exclusive. The argument advanced is essentially that some leases contain clauses that make the lessee's obligation absolute and unconditional, and because the obligation is absolute, such clauses should be made the determinant for capitalization of leases containing them. Those advancing this view generally appeared to be focusing on the liability aspect of the transaction rather than on the nature of the corresponding asset to be recorded. Few had any comment to offer concerning cases in which the "legal debt" assumed by the lessee represents only a portion of the asset's cost; nor was it clear from the comments how, if at all, the concept of "legal debt" standing alone should affect accounting for the lease by the lessor.

71. The Board noted that the determination of whether a lease obligation represents debt in the strict legal sense would of necessity rest primarily on court decisions, and that such decisions have arisen almost entirely from litigation involving bankruptcy, reorganization, or taxation. The Board concluded that legal distinctions of this nature were apt to be neither relevant nor practical in application to the accounting issue of lease capitalization. The Board believes further that, in most instances where the lessee has assumed an unconditional obligation that the courts might hold to be legal debt, it is reasonable to assume that he will have protected his interest through other features in the agreement that are likely to meet one or more of the criteria for capitalization stated in paragraph 7. The Board accordingly rejected the concept of "legal debt" as a determinant for lease capitalization.

#### **Criteria for Classification**

72. The Discussion Memorandum listed 14 criteria as having some support for use in classifying leases by lessees. A number of criteria, including some of

the 14, were also listed for possible use in classifying leases by lessors. Among the respondents, opinion was divided as to the criteria that identify leases that should be capitalized by the lessee as well as to those criteria that identify leases that should be recorded as sales or financing leases by lessors. The Board concluded that many of the listed criteria were overlapping, i.e., that the basic idea contained in one also was embodied in others designed to identify the same attribute. The Board believes that the criteria stated in paragraphs 7 and 8 contain the essence of the listed criteria except those that the Board did not consider relevant or suitable. The basis for the Board's adoption or rejection of individual criteria is the concept discussed in paragraph 60, namely, the transfer of substantially all of the benefits and risks incident to the ownership of property. The following discusses the Board's conclusions with respect to each of the 14 criteria listed in the lessee section of the Discussion Memorandum together with 5 other criteria that were dealt with in the lessor section. These last 5 are discussed in paragraphs 87-90.

73. *Lessee builds up a material equity in the leased property.* Many of the respondents favored the material equity criterion as contained in *APB Opinion No. 5* as the principal basis for lease capitalization by the lessee. Of the criteria selected by the Board, the criterion stated in paragraph 7(b) wherein the lease contains a bargain purchase option is evidential that a material equity is being established. The criterion stated in paragraph 7(a) wherein ownership is transferred by the end of the lease term may in some circumstances be evidential that a material equity is being established. However, in relating material equity to the concept discussed in paragraph 60, the Board concluded that leases in which no material equity is established by the lessee may effectively transfer substantially all of the benefits and risks of ownership. For example, a lease whose term extends over the entire economic life of the asset and thus transfers all of the benefits and risks of ownership need not give rise to a material equity. Accordingly, the Board rejected material equity as a separate criterion and considered it too limiting to represent the central basis for lease capitalization by lessees.

74. *Leased property is special purpose to the lessee.* The Board rejected this criterion for two reasons. First, "special purpose property" is a relative concept that is hard to define objectively. Second, the fact that the leased property is special purpose does not, of itself, evidence a transfer of substantially all of the benefits and risks of asset ownership. Although it is

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expected that most lessors would lease special purpose property only under terms that transfer substantially all of those benefits and risks to the lessee, nothing in the nature of special purpose property necessarily entails such lease terms. The Board concluded that, if the lease, in fact, contains such terms, it is likely that one or more of the adopted criteria in paragraph 7 would be met.

*75. Lease term is substantially equal to the estimated useful life of the property.* This criterion was modified as adopted in criterion (c) of paragraph 7 as follows:

The lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)).

In the Board's view, the fact that the lease term need be for only 75 percent of the economic life of the property is not inconsistent with the concept discussed in paragraph 60 for the following reasons:

Although the lease term may represent only 75 percent of the economic life of the property in terms of years, the lessee can normally expect to receive significantly more than 75 percent of the total economic benefit to be derived from the use of the property over its life span. This is due to the fact that new equipment, reflecting later technology and in prime condition, can be assumed to be more efficient, and hence yield proportionately more use benefit, than old equipment which has been subject to obsolescence and the wearing-out process. Moreover, that portion of use benefit remaining in the equipment after the lease term, in terms of the dollar value that may be estimated for it, when discounted to present worth, would represent a still smaller percentage of the value of the property at inception.

As a result of comments received in response to the second Exposure Draft, the following qualification has been added to paragraph 7(c):

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.

The Board found persuasive the argument that it would be inconsistent to require that a lease covering the last few years of an asset's life be recorded as a capital lease by the lessee and as a sales-type or direct financing lease by the lessor when a lease of the asset for a similar period earlier in its life would have been classified as an operating lease. Without the above qualification, in the case of a tank car having an estimated economic life of 25 years and placed under five successive 5-year leases, the first four leases would be classified as operating leases under this criterion and the last lease would be classified as a capital lease. The Board considered such a result illogical.

*76. Lessee pays costs normally incident to ownership.* This criterion was rejected by the Board since it can be presumed that, one way or another, the lessee bears the costs of ownership in virtually all lease agreements.

*77. Lessee guarantees the lessor's debt with respect to the leased property.* The Board concluded that this criterion does not necessarily evidence a lease that transfers substantially all of the benefits and risks of property ownership; the amount guaranteed may represent only a portion of the fair value of the property. When there is a guarantee, the Board believes it likely that the lessee will have protected his interest through other features in the agreement that may meet one or more of the adopted criteria stated in paragraph 7. In this regard, any periods covered by renewal options in which a lessee guarantee is expected to be outstanding are to be included in the lease term, as provided by paragraph 5(f), and the corresponding renewal rentals are to be included in minimum lease payments, as provided by paragraph 5(j). Thus, such periods would be recognized in applying criterion 7(c) to the property's economic life, and both the periods and the corresponding rentals would be recognized in applying the 90 percent recovery criterion (paragraph 7(d)).

*78. Lessee treats the lease as a purchase for tax purposes.* The Board rejected this criterion. There are many instances in which tax and financial accounting treatments diverge, and the question of a possible need for conformity between them is beyond the scope of this Statement.

*79. Lease is between related parties.* The Board did not consider this criterion as suitable, in itself, for determining lease classification. Leases between related parties are discussed in paragraphs 29–31.

*80. Lease passes usual risks and rewards to lessee.* The Board considered this to be a concept rather than



a criterion. It is closely related to the basic concept underlying the conclusions of this Statement, described in paragraph 60.

81. *Lessee assumes an unconditional liability for lease rentals.* This criterion was rejected by the Board for the reasons given in paragraph 71.

82. *Lessor lacks independent economic substance.* The Board considered the argument advanced by some that, if the lessor has no economic substance, the lessor serves merely as a conduit in that the lender looks to the lessee for payment and thus, it is asserted, the lessee is, in fact, the real debtor and purchaser. Whether the lessee is judged to be a debtor does not, in the Board's view, constitute a suitable criterion for determining lease classification for the reasons expressed in paragraph 71. The Board finds unpersuasive the argument that the lessee's accounting for a leasing transaction should be determined by the economic condition of an unrelated<sup>30</sup> lessor. If a lease qualifies as an operating lease because it does not meet the criteria in paragraph 7, the Board finds no justification for requiring that it be accounted for as a capital lease by the lessee simply because an unrelated lessor lacks independent economic substance. In such a case, it probably means that someone else, presumably the lender, is in substance the lessor, but this circumstance, per se, should not alter the lessee's accounting. Accordingly, the Board rejected this criterion.

83. *Residual value at end of lease is expected to be nominal.* Some respondents recommended that such a criterion, if adopted, should be based on the present value of the residual, which, because of the long-term nature of many leases, would represent a much smaller percentage of asset value at inception than the undiscounted residual value. However, other respondents who favored the addition of a recovery criterion based on the relationship of the present value of the lease payments to the fair value of the leased property argued that a criterion based on residual value would be redundant in that it would essentially measure the complement of that relationship. Since, for the reasons set forth in paragraph 84 below, the Board favored the recovery criterion, it was adopted in lieu of a criterion based on residual values.

84. *Lease agreement provides that the lessor will recover his investment plus a fair return (a) guaranteed by the lessee or (b) not so guaranteed.* A variation of

this criterion was adopted as criterion (d) of paragraph 7. In the form adopted, the criterion is met when the present value of the minimum lease payments, defined in paragraph 5(j), excluding executory costs, equals or exceeds 90 percent of the excess of the fair value of the leased property, defined in paragraph 5(c), 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. The Board concluded that if the present value of the contractual receipts of the lessor provide for recovery of substantially all (defined as 90 percent or more) of his net investment in the fair value of the leased asset, the lessor has transferred substantially all of the benefits and risks of asset ownership. Likewise, if the present value of the lessee's lease obligations provide for that degree of recovery by the lessor, the conclusion was that the lessee has acquired those benefits and risks. Some respondents pointed out that a recovery criterion more clearly evidences the transfer of risks than of benefits since a substantial residual value may revert to the lessor at the end of the lease term. However, the Board concluded that, in leases meeting the recovery criterion, the residual amount, when discounted to its present value at the inception of the lease, is likely to represent only a small percentage of the fair value of the property. For the reasons cited above, the Board adopted a criterion based on recovery of substantially all (defined as 90 percent or more) of the fair value of the leased property. A lessee guarantee of recovery to the lessor is recognized through inclusion in the definition of minimum lease payments. Thus, such guarantees are taken into account in the application of the 90 percent recovery criterion. As a result of comments received in response to the second Exposure Draft, the following qualification has been added to paragraph 7(d):

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.

The above qualification is the same as that added to criterion 7(c) and the reasons are the same as those discussed in paragraph 75.

85. *Lessee has the option at any time to purchase the asset for the lessor's unrecovered investment.* The

<sup>30</sup>If the lessee and the lessor are related parties, the provisions of paragraphs 29–31 apply.



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Board concluded that the existence of a purchase option is significant only if it is a bargain purchase option as defined in paragraph 5(d) and as adopted in paragraph 7(b); otherwise, there is no presumption that the lessee will exercise the option. Accordingly, the Board rejected this criterion.

86. *Lease agreement is noncancelable for a "long term."* This criterion was rejected by the Board in favor of criterion (c) of paragraph 7.

87. *Lease transfers title (ownership) to the lessee by the end of the lease term.* This criterion was adopted by the Board as criterion (a) of paragraph 7. Such a provision effectively transfers all of the benefits and risks of ownership and, thus, the criterion is consistent with the concept discussed in paragraph 60.

88. *Lease provides for a bargain purchase or a renewal option at bargain rates.* The existence of a bargain purchase option was adopted by the Board as criterion (b) of paragraph 7. Such a provision effectively transfers all of the benefits and risks of ownership and, thus, the criterion is consistent with the concept discussed in paragraph 60. The period covered by a bargain renewal option is included in the lease term, as defined in paragraph 5(f), and the option rentals are included in minimum lease payments, as defined in paragraph 5(j). Thus, a bargain renewal option enters into the determination of whether the lease meets either criterion (c) or criterion (d) of paragraph 7. Accordingly, the Board rejected the existence of a bargain renewal option as a separate criterion.

89. *Collection of the rentals called for by the lease is reasonably assured.* This criterion relates only to lessors. It has been restated as follows and adopted by the Board as a necessary criterion (paragraph 8(a)): "Collectibility of the minimum lease payments is reasonably predictable." The wording change reflects the Board's view that lessors should not be precluded from classifying leases as direct financing or sales-type leases, when they meet one of the criteria for such classification in paragraph 7, if losses are reasonably predictable based on experience with groups of similar receivables. When other than normal credit risks are involved in a leasing transaction, it was the Board's conclusion that collectibility is not reasonably predictable and classification as a sales-type or direct financing lease, in such cases, is therefore not appropriate.

90. *No important uncertainties surround costs yet to be incurred by lessor.* The matter of uncertainties sur-

rounding future costs was dealt with in the Discussion Memorandum as one of the risks of ownership relevant to the classification of leases by lessors. This criterion is essentially equivalent to one of the criteria set forth in *APB Opinion No. 27*, paragraph 4, as a requirement for treating a lease by a manufacturer or dealer lessor as a sale. In adopting this as a necessary criterion, the Board believes that if future unreimbursable costs to be incurred by the lessor under the lease are not reasonably predictable, the risks under the lease transaction may be so great that it should be accounted for as an operating lease instead of as a sales-type or direct financing lease.

### Accounting by Lessees

91. *APB Opinion No. 5*, paragraph 15, prescribed accounting for leases that were to be capitalized as "in substance installment purchases" as follows:

Leases which are clearly in substance installment purchases of property . . . should be recorded as purchases. The property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement. . . . The method of amortizing the amount of the asset to income should be appropriate to the nature and use of the asset and should be chosen without reference to the period over which the related obligation is discharged.

As stated in paragraph 60, the concept underlying this Statement is 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. The concept for capitalization by the lessee of only those leases that are "in substance installment purchases" was rejected by the Board as too limiting a basis for lease capitalization (see paragraph 69).

92. Despite this difference in the concept for capitalization, the Board viewed the accounting prescribed by *APB Opinion No. 5* for capitalized leases as generally appropriate. While respondents expressed varying opinions as to the characteristics of leases that should be capitalized, there was little opposition to the method of accounting for such leases prescribed by *APB Opinion No. 5*. The accounting provisions of this Statement applicable to lessees, with the exceptions noted below, generally follow that Opinion; however, these provisions are more specific with respect to implementation.

93. With respect to the rate of interest to be used in determining the present value of the minimum lease payments for recording the asset and obligation under a capital lease, the Board concluded the rate should generally be that which the lessee would have incurred to borrow for a similar term the funds necessary to purchase the leased asset (the lessee's incremental borrowing rate). An exception to that general rule occurs when (a) it is practicable for the lessee to ascertain the implicit rate computed by the lessor and (b) that rate is less than the lessee's incremental borrowing rate; if both of those conditions are met, the lessee shall use the implicit rate. However, if the present value of the minimum lease payments, using the appropriate rate, exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value. A number of respondents pointed out that in many instances, the lessee does not know the implicit rate as computed by the lessor. Also, since the implicit rate is affected by the lessor's estimate of the residual value of the leased property in which the lessee will usually have no interest, and may also be affected by other factors extraneous to the lessee, it may, if higher than the lessee's incremental borrowing rate, produce a result that is less representative of the transfer of use benefit to the lessee than would be obtained from use of the lessee's incremental borrowing rate. For those reasons, the Board concluded that the lessee's use of the implicit rate for discounting purposes should be limited to circumstances in which he is able to ascertain that rate, as computed by the lessor, and it is less than his incremental borrowing rate. In the revised Exposure Draft, the Board had defined this rate as that which "the lessee would have incurred to borrow the funds necessary to buy the leased asset on a secured loan with repayment terms similar to the payment schedule called for in the lease." A number of respondents objected to this definition pointing out that they would not have financed the asset on a secured loan basis and, hence, would be unable to determine such a theoretical rate. Those respondents suggested that the definition be revised to allow the lessee to use a rate consistent with the type of financing that would have been used in the particular circumstances. The Board found merit in those suggestions because it intended that the rate should be both determinable and reasonable. The definition of the lessee's incremental borrowing rate has been revised accordingly. Some respondents pointed out that the use of the lessee's incremental rate, however determined, would in some cases produce an amount to be capitalized that would be

greater than the known fair value of the leased asset. It was suggested that in such cases the amount to be capitalized be limited to the fair value. The Board agreed with that recommendation.

94. The method of amortization of the capitalized asset prescribed in this Statement (see paragraph 11) differs from that called for in *APB Opinion No. 5* in that, except for those leases that meet criterion 7(a) or 7(b), the period of amortization is limited to the lease term. *APB Opinion No. 5* did not so limit the period of amortization since the leases to be capitalized were those that were considered "in substance installment purchases." The Board concluded that, for leases which are capitalized under criterion 7(c) or 7(d) of this Statement, the amortization period should be the lease term. It is presumed for accounting purposes that, in such leases, the lessee's period of use of the asset will end at the expiration of the lease term.

95. Some respondents asked for clarification and more specific treatment in the Statement with respect to the accounting to be followed in connection with the situations referred to in paragraph 9 having to do with changes in lease provisions that would have resulted in a different classification of the lease at its inception and renewals and extensions of existing leases. The clarification requested has been incorporated in paragraph 14. Additionally, respondents asked for clarification with respect to the accounting to be followed when a guarantee or penalty provision in a lease is rendered inoperative by a renewal or extension. That clarification has been provided in paragraph 12.

#### **Disclosure by Lessees**

96. Users of financial statements have indicated a strong desire for disclosure by lessees of information concerning leasing transactions whether leases are capitalized or not. In some cases, the information desired was similar to that now provided in accordance with *APB Opinion No. 31* or *SEC Accounting Series Release No. 147*. However, some respondents objected to the requirement to disclose future minimum rental payments by periods beyond the next succeeding five years. It was contended that any such projections are apt to be misleading since the accumulating effect of new leases and lease renewals on future payments in those periods is not reflected. In addition, some users and many other respondents opposed requiring disclosure of the estimated effect on net income had certain leases been capitalized. The Board agreed with both of those views except that during

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the transition period until full retroactive application of this Statement is required, the Board decided that the disclosure called for in paragraph 50 is needed by users of financial statements pending retroactive application. The Board concluded that the disclosures called for in paragraph 16(a) with respect to capital leases would provide information helpful to users of financial statements in assessing the financial condition and results of operations of lessees. In the Board's view, such disclosures are consistent with the information presently required to be disclosed with respect to owned property and to long-term obligations in general. The Board further concluded that users' assessments would be facilitated by the disclosures called for in paragraphs 16(b) and 16(c) with respect to operating leases. The requirement to disclose information concerning commitments for rental payments under operating leases during the succeeding five years is consistent with the similar requirement for capital leases.

### **Accounting by Lessors**

97. As stated in paragraph 61, the concept underlying the accounting for leases by lessors in this Statement is essentially the same as the concept embodied in *APB Opinions No. 7* and *27*; that is, a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as a sale or financing by the lessor. Accordingly, the accounting provisions of this Statement applicable to lessors, with the principal exceptions noted below, generally follow those of the two APB Opinions.

98. In computing the manufacturer's or dealer's profit on a sales-type lease, the cost of the property leased will be reduced by the present value of the estimated residual value. This represents a liberalization of the provisions of *APB Opinion No. 27*, which did not permit recognition of any residual value in determining manufacturer's or dealer's profit. Some respondents favored continuing the provisions of *Opinion 27* in this regard. Others believed that the present value of the residual should be recognized in profit determination and that the accounting for the financing element of a leasing transaction should be essentially the same in a sales-type lease as in a direct financing lease. The Board agreed with this latter view and concluded that the difference between the estimated residual and its present value should be included in unearned income and recognized in income over the lease term.

99. This Statement calls for the estimated residual value, along with rentals and other minimum lease payments receivable, to be included in the balance sheet presentation of the investment in sales-type and in direct financing leases. Under *APB Opinion No. 7*, the estimated residual value was to be included with property, plant, and equipment. Several respondents contended that inclusion of the residual with depreciable assets of the lessor would blur the distinction between property on lease and property used in the lessor's internal operations. Others pointed out that, in the vast majority of leases, the estimated residual value is realized by a sale or re-lease of the property and, for that reason, the residual should be looked upon as a last payment similar to the minimum lease payments. In addition, it was contended, presentation of the estimated residual value as part of the lease investment rather than as part of property, plant, and equipment is necessary to portray the proper relationship between the gross investment in leases and the related unearned income, since a portion of the unearned income relates to the residual value. The Board agreed with those views.

100. This Statement requires that the selling price in a sales-type lease be determined by computing the present value of payments required under the lease. In this respect, it follows *Opinion 27*. However, this Statement is more specific than *Opinion 27* in identifying the payments that are to be included in the computation, and it requires use of the rate of interest implicit in the lease for discounting instead of an interest rate determined in accordance with the provisions of *APB Opinion No. 21*, as called for by *Opinion 27*. Use of the latter rate was rejected by the Board on the grounds that it would yield an amount to be recorded as the sales price that would be at variance with the known fair value of the leased asset (after adjusting that price for the present value of any investment tax credit or residual retained).

101. This Statement requires different treatment of initial direct costs (see paragraph 5(m)) as between sales-type leases and direct financing and leveraged leases. In the case of sales-type leases, initial direct costs are to be charged against income of the period in which the sale is recorded, which is consistent with the general practice of accounting for similar costs incurred in connection with installment sales on the basis that such costs are incurred primarily to produce sales revenue. In this respect, the Statement follows *APB Opinion No. 27*, which, although not mentioning initial direct costs specifically, in paragraph 6 called for estimated "future costs" related to leases accounted for as sales to be charged to income of the



period in which the sale is recorded. The second Exposure Draft called for initial direct costs incurred in connection with direct financing leases to be accounted for in the manner that *APB Opinion No. 7*, paragraph 11, described as preferred, that is, to be deferred and allocated to future periods in which the related financing income is reported. This requirement recognized that, unlike the initial direct costs in sales-type leases, such costs in direct financing leases are not primarily related to income of the period in which the costs are incurred. A number of respondents objected to the deferral of initial direct costs incurred in connection with direct financing leases because it is at variance with predominant industry practice and would, it was reported, necessitate a major revision of existing record systems and computer programs with no appreciable effect on net income over the lease term. The predominant industry practice as cited by those respondents consists of expensing such costs as incurred and recognizing as income in the same period a portion of unearned income equal to the amount of the costs expensed. It was pointed out that this method produces essentially the same income effect as if the initial direct costs were deferred and amortized separately, as was called for by the revised Exposure Draft, or as if these costs were charged to unearned income, as is called for in the case of leveraged leases. The Board accepted this recommendation for practical considerations and has revised the accounting prescribed for initial direct costs incurred in connection with direct financing leases accordingly. In the case of leveraged leases, the accounting for initial direct costs is consistent with the central concept underlying the accounting for leveraged leases by the investment with separate phases method, that concept being that the net income should be recognized at a level rate of return on the investment in the lease in the years in which the investment is positive.

102. As was the case with lessee accounting, respondents requested clarification and more specific guidance as to the accounting to be followed by lessors with respect to the situations referred to in paragraph 95. The requested guidance for lessor accounting for those situations has been provided in paragraphs 17(e) and 17(f). In addition, respondents objected to the provisions of the revised Exposure Draft allowing, in some instances, gain to be recognized immediately on renewals or extensions of sales-type or direct financing leases. Those who objected contended that gain recognition in those circumstances was equivalent to allowing upward revisions

of residual value estimates, a practice specifically prohibited in the Statement. The Board found those objections persuasive and, accordingly, revised the accounting for renewals or extensions of sales-type or direct financing leases to prohibit immediate recognition of gain.

#### **Disclosure by Lessors**

103. A number of those respondents who addressed the question of what information should be disclosed by lessors thought that the disclosures called for by *APB Opinion No. 7* were adequate. Some, however, thought there should be consistency, where relevant, between the disclosure requirements for lessors and those for lessees and noted that disclosure requirements for lessees had been recently made more extensive by *APB Opinion No. 31* and *SEC Accounting Series Release No. 147*. The Board agreed with this latter view. As in the case of lessees, the Board believes that the information required to be disclosed by paragraph 23 will be helpful to users of financial statements in assessing the financial condition and results of operations of lessors. Several respondents to the second Exposure Draft objected to the limitation of lessor disclosure requirements to those lessors for which leasing is the predominant activity. It was contended that the disclosures should be required whenever leasing is a significant part of the lessor's business activities rather than only when leasing is predominant. Other respondents thought that a single test of predominance based on revenues was inappropriate and pointed to the difference in the nature of lease rentals as compared to sales revenue of a manufacturing concern. It was recommended that significance be determined in terms of revenue, net income, or assets as separate indicators. The Board found merit in these recommendations and revised the disclosure limitation accordingly.

104. Some respondents recommended the elimination of the requirement in the Exposure Drafts that the cost or carrying amount of property on operating leases and that of property held for lease be separately disclosed. They contended that in companies having thousands of operating leases it would be difficult, if not impossible, to make such a split. Since the information would be based on one particular point in time, it may well be unrepresentative. The Board found those arguments persuasive and believes, moreover, that a better indication of the productivity of property on or held for lease is its relationship to the minimum future rentals by years and

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in the aggregate from noncancelable operating leases, which latter information is required by the Statement.

### **Leases Involving Real Estate**

105. The second Exposure Draft provided that criteria 7(c) and 7(d) were not applicable to leases of land and that, unless criterion 7(a) or 7(b) was met, leases of land should be accounted for as operating leases. In a lease involving both land and building, if the land element represented 15 percent or more of the total fair value of the leased property, the land and building elements of the lease were required to be separated and each classified and accounted for as if it were a separate lease. Some respondents objected to this, contending that the recovery criterion, 7(d), should be applicable to land leases the same as to other leases. Others objected to the required separate treatment of the land and building elements in a lease involving both, contending that the property should be classified and accounted for as a unit and that to require separation would be inconsistent with the economic substance of the transaction. Some, particularly in the case of retail leases, cited the difficulties and cost involved in separating the land and building elements for companies with large numbers of such leases. They recommended that separation not be required and that all such leases be classified as operating leases. However, if separation were to continue to be required, some suggested that the 15 percent limitation be raised to permit treating as a unit a greater number of leases in which land would still not represent a major element. The Board's conclusion that, unless criterion 7(a) or 7(b) was met, leases of land should be classified as operating leases is based on the concept that such leases do not transfer substantially all the benefits and risks of ownership. Land normally does not depreciate in value over time, and rental payments for the use of land are not predicated on compensation for depreciation plus interest, as is the case with leases of depreciable assets, but are in the nature of interest only or, as some may prefer to say, interest plus whatever additional profit element may be included. The requirement for separation of the land and building elements in a lease involving both is based on this distinction. The Board found merit, however, in the recommendation that the 15 percent limitation be raised in order to reduce the practical problems involved in separating the land and building elements for large numbers of leases. The Board concluded that the 15 percent limitation established in the second Exposure Draft should accordingly be raised to 25 percent.

106. A number of respondents pointed out that leases of facilities such as airport and bus terminals and port facilities from governmental units or authorities contain features that render the criteria of paragraph 7 inappropriate for classifying such leases. Leases of such facilities do not transfer ownership or contain bargain purchase options. By virtue of its power to abandon a facility during the term of a lease, the governmental body can effectively control the lessee's continued use of the property for its intended purpose, thus making its economic life essentially indeterminate. Finally, since neither the leased property nor equivalent property is available for sale, a meaningful fair value cannot be determined, thereby invalidating the 90 percent recovery criterion. For those reasons, the Board concluded that such leases shall be classified as operating leases by both the lessee and lessor.

### **Sale-Leaseback Transactions**

107. Of those respondents who addressed the issues of accounting for sale-leaseback transactions, opinions were divided between those who favored (a) treatment as a single transaction with deferral of profit on the sale and (b) treatment as two independent transactions unless the lease meets criteria for capitalization by the lessee. Generally, those favoring treatment as a single transaction would make certain exceptions, such as "leasebacks to accommodate a short-term property requirement of the seller" and "leasebacks of only a relatively small part of the property sold." The Board noted that most sale-leasebacks are entered into as a means of financing, for tax reasons, or both and that the terms of the sale and the terms of the leaseback are usually negotiated as a package. Because of this interdependence of terms, no means could be identified for separating the sale and the leaseback that would be both practicable and objective. For that reason, the Board concluded that the present general requirement that gains and losses on sale-leaseback transactions be deferred and amortized should be retained. An exception to that requirement arises when the fair value of the property at the time of the transaction is less than its undepreciated cost. In that case, the Board decided that the loss should be recognized up to the amount of the difference between the undepreciated cost and fair value.

### **Accounting for Leveraged Leases by Lessors**

108. The first issue concerning leveraged leases in the Discussion Memorandum asked whether lever-

aged leases are unique in the sense that special standards are required to recognize their economic nature. The affirmative responses to this issue generally gave as reasons the arguments stated in the Discussion Memorandum. The essence of those arguments is that the combination of nonrecourse financing and a cash flow pattern that typically enables the lessor to recover his investment in the early years of the lease and thereafter affords him the temporary use of funds from which additional income can be derived produces a unique economic effect. Those respondents who did not agree that leveraged leases are unique generally cited the contra argument in the Discussion Memorandum, namely, that each of the attributes of leveraged leases that serve to support the uniqueness claim has its counterpart in other types of business transactions. Information communicated by respondents, as well as that obtained through staff investigation, indicates that the use of a variety of accounting methods for leveraged leases has grown rapidly. The methods in use generally correspond, although frequently with variations, to those illustrated in the Discussion Memorandum. The Board noted with concern the increasing disparity in practice in accounting for leveraged leases. Despite the fact that each of the attributes of a leveraged lease is found in other types of transactions, the Board believes that in a leveraged lease those attributes are combined in a manner that produces an overall economic effect that is distinct from that of other transactions. Accordingly, the Board concluded that a leveraged lease, as defined in paragraph 42, should be accounted for in a manner that recognizes this overall economic effect. However, the Board emphasizes that the qualification "as defined in paragraph 42" is an important one since the term "leveraged lease" is used by some respondents to refer to any lease involving nonrecourse debt. There is further discussion of this distinction in paragraph 110.

109. The Discussion Memorandum described and illustrated four different methods of accounting for leveraged leases. Three of those methods are designed to recognize what their adherents see as the economic effect of a leveraged lease, while the other method, the ordinary financing lease method, is that presently prescribed for financing leases by *APB Opinion No. 7*. The Board's conclusions and the reasons therefor concerning the four methods are as follows:

a. *The ordinary financing lease method.* This accounting method makes no distinction between a leveraged lease and an ordinary two-party financ-

ing lease. Even though the debt is nonrecourse to the lessor and the lessor has no claim on the debt service payments, the transaction is recorded "gross" with the lessor's investment based on the present value of the gross rentals plus the residual value as prescribed by *APB Opinion No. 7*. In fact, however, the lessor's real investment is not a function of the amount of the future rental payments, which amount represents neither the funds he has at risk nor the asset from which he derives earnings. Further, no recognition is given to the separate investment phases of a leveraged lease as defined in paragraph 42. This method was rejected by the Board because it is incompatible with the essential features of the transaction.

b. *The three-party financing lease method.* This method does reflect the three-party nature of the transaction in that the lessor's investment is recorded net of the nonrecourse debt, and rental receipts are reduced by the debt service payments. However, it gives no recognition to the fact that a leveraged lease has separate investment phases, which is one of the characteristics included in the definition (see paragraph 42(d)). The lessor's unrecovered investment balance declines during the early years of a leveraged lease from the strong cash inflow in that period. Typically, the cumulative cash inflow during the early years exceeds the investment, producing a negative investment balance during the middle years. The investment returns to a positive balance again in the later years as funds are reinvested and then goes to zero with realization of the residual value at the termination of the lease. This pattern of cash flow results from the fact that income tax reductions from the investment tax credit, accelerated depreciation, and greater interest deductions in earlier years are replaced by additional income taxes in the later years after the investment tax credit has been utilized and as tax benefits from depreciation and interest diminish. By ignoring these separate investment phases, the three-party financing method shows a gradually declining investment balance throughout the years of the lease, with income recognized at a level rate of return on the declining balance. The Board believes that the accounting treatment for a leveraged lease should reflect these separate investment phases, which have different economic effects, and should provide for the recognition of income in appropriate relation to them. To do otherwise, in the Board's view, is to negate the reason for having a separate standard for leveraged



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leases, that reason being that leveraged leases have a distinct combination of economic features that sets them apart from ordinary financing leases. While the three-party financing lease method reflects the three-party nature of the transaction, it fails to recognize the other economic features referred to above; as a consequence, it produces results that are inconsistent with the manner in which the lessor-investor views the transaction. For those reasons, the Board rejected the three-party financing lease method.

- c. *The investment with separate phases method.* This method recognizes the separate investment phases and the reversing cash flow pattern of a leveraged lease. By recognizing income at a level rate of return on net investment in the years in which the net investment is positive, it associates the income with the unrecovered balance of the earning asset in a manner consistent with the investor's view of the transaction. In the middle years of the lease term, the investment balance is generally negative, indicating that the lessor has not only recovered his initial investment but has the temporary use of funds that will be reinvested in the later years. The earnings on these temporary funds are reflected in income as and if they occur in the years in which the investment is negative. The income that is recognized at a level rate of return in the years in which the net investment balance is positive consists only of the so-called "primary" earnings from the lease, as distinct from the earnings on temporary funds to be reinvested, sometimes referred to as "secondary" earnings. The lessor-investor looks upon these secondary earnings from the temporarily held funds as one of the economic benefits inherent in the transaction. The integral investment method discussed in (d) below allocates both the primary and secondary earnings to annual income on a level rate of return basis. It is asserted by some that because of this feature, the integral investment method is more consistent with the manner in which the lessor-investor views the transaction. However, this feature involves estimation of the secondary earnings and recognition of a substantial portion of them in advance of their occurrence, which the Board did not favor for reasons stated below in the discussion of the integral investment method. The Board believes that secondary earnings should be recognized in income only as they occur (in the negative investment years), and that this treatment, coupled with the

recognition of primary earnings in the positive investment years, appropriately portrays the economic effects of the separate investment phases. Accordingly, the Board concluded that the investment with separate phases method as prescribed in paragraphs 43–47 is the appropriate method for accounting for leveraged leases.

- d. *The integral investment method.* Several variations of the method illustrated in Schedule 7, page 126, of the Discussion Memorandum were suggested by respondents who supported its concept. That concept looks upon the earnings from the use of temporarily held funds (discussed in (c) above) as constituting an integral part of the lease income, rather than as secondary earnings to be accounted for as they occur (the treatment called for in the separate phases method). Advocates of the integral method point out that the equity participant (lessor) in a leveraged lease is actually buying a series of cash flows consisting not only of the equity portion of the rental payments, the investment tax credit and other tax benefits, and the amount to be realized from the sale of the residual, but also including the earnings to be obtained from the use of temporarily held funds. Failure to include the latter in the calculation and recognition of lease income, in their view, understates lease income and is inconsistent with the manner in which the lessor-investor views the transaction. In considering these arguments, the Board noted (1) that the earnings in question, in effect, represent an estimate of interest expected to be earned (or interest cost to be saved) in future years through the application of the temporarily held funds; (2) although these earnings will not be realized until future years, their inclusion in lease income under the integral investment method would result in their recognition in substantial amounts beginning with the first year of the lease; and (3) the actual occurrence and amount of those earnings cannot be verified because this would involve tracing the source of specific investment dollars, generally acknowledged to be impractical. The Board noted further that the other cash flows that constitute the source of the primary earnings, with the exception of the residual value, are either contractual or based on existing tax law and thus provide a firmer basis for income recognition than the secondary earnings. Admittedly, there is uncertainty involved in the estimate of residual value to be realized; however, the Board noted that recognition of residual value is consistent with the accounting prescribed

for ordinary financing leases, whereas the anticipation of future interest on funds expected to be held temporarily has no support in present generally accepted accounting principles. For the foregoing reasons, the Board rejected the integral investment method.

110. Some respondents who objected to the inclusion of paragraph 42(d) in the definition of a leveraged lease argued that leveraged leases can have a variety of rental payment arrangements, some of which would not produce the separate investment phases specified as part of the definition, but that, nevertheless, such leases should be accorded the accounting method prescribed in the Statement. The Board did not agree with this view, since the method prescribed is designed to recognize the unique economic aspects of the separate investment phases. It concluded that leases not having this characteristic should not be accounted for as leveraged leases and that the presence of nonrecourse debt in a leasing transaction is not by itself justification for special accounting treatment. Nonrecourse debt occurs in many types of transactions other than leases and, as discussed in paragraph 108, it is only the combination of attributes, not the presence of nonrecourse debt alone, that produces an overall economic effect that is distinct from that of other transactions.

111. Some have contended that the inclusion of deferred taxes in the determination of the lessor's unrecovered investment is what gives rise to the separate investment phases, which is then used to justify the Board's adoption of the separate phases method and its rejection of the three-party financing method. The Board believes that the essential difference between the three-party financing method and the separate phases method is that the latter method closely follows the cash flow of the transaction, whereas the former does not. The three-party financing method portrays a gradually declining investment balance over the entire lease term, thus failing to recognize the short-term nature of the lessor's initial investment, which is typically recovered through the cash flow in the early years of the lease. That this early cash flow comes in large part from tax benefits does not alter the fact that the lessor has recovered his investment and is then provided with the temporary use of funds by which additional income can be generated. It is this feature which provides much of the incentive for the lessor to enter into the transaction in the first place and, in fact, without those tax benefits some leveraged leases would yield negative results. The Board concluded that leveraged leases should be

accounted for in a manner that recognizes this cash flow pattern, both in determining the lessor's unrecovered investment balance and in the allocation of income relating to it. The assertion by some that the separate phases method results in an unwarranted "front ending" of income, in the Board's view, fails to take into account that the economic benefits of the transaction are themselves "front-ended," as has been described above. It is precisely this feature and the lack of recognition given it by the three-party financing method that caused the Board to reject that method.

112. A number of respondents to the second Exposure Draft objected to the exclusion of the 90 percent recovery criterion, 7(d), in determining whether or not a lease meets the requirement of paragraph 42(a) as part of the definition of a leveraged lease. These respondents pointed out that the majority of leveraged leases would not meet any of the other criteria of paragraph 7 and that, if criterion 7(d) was not to be applicable, few leases would meet the definition of a leveraged lease. They took exception to the Board's reasons for having excluded criterion 7(d) as expressed in the second Exposure Draft. In their view, the determination of whether the lease would qualify as a direct financing lease, as required by paragraph 42(a), should be made in the same manner as with any other lease and that the presence of nonrecourse debt should thus not enter into such determination. The Board agreed with this reasoning and has changed the requirement of paragraph 42(a) accordingly.

113. Some respondents asked that the Board reconsider its decision reflected in the second Exposure Draft that leases meeting the definition of sales-type leases should not be accounted for as leveraged leases. The argument was advanced that manufacturers and dealers often engaged in leasing transactions that, except for the exclusion of sales-type leases, would otherwise meet the definition of a leveraged lease as set forth in paragraph 42. Specifically, it was asked why should not a manufacturer record manufacturing profit for a sales-type lease and then also account for it as a leveraged lease, if it otherwise meets the definition? In the Board's view, the recognition of manufacturing profit by the lessor at the beginning of the lease is incompatible with the concept underlying the accounting method prescribed by this Statement for leveraged leases. As stated in paragraph 109(c), that method recognizes income at a level rate of return on the lessor's net investment in the years in which the net investment is positive. The



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annual cash flow is thus allocated between that portion recognized as income and that applied as a reduction of net investment. Net investment at any point is considered to represent the lessor's unrecovered investment. If manufacturing profit is recognized at the beginning of the lease, an element of the overall profit in the transaction has been abstracted at the outset, thus changing the pattern of income recognition contemplated. The lessor's investment as recorded after recognition of manufacturing profit would not represent his unrecovered investment. That fact plus the deferral of income taxes related to the manufacturing profit recognized would alter both the investment base and the income to be allocated, thus departing from the cash flow concept on which the prescribed method is based. For these reasons, the Board did not accept the recommendation.

114. For much the same reason, the Board concluded that if the investment tax credit is accounted for other than as described in paragraphs 43 and 44, the leveraged lease should not be accounted for by the investment with separate phases method but, instead, by the method prescribed for a direct financing lease. Accounting for the credit other than as prescribed by the investment with separate phases method would abstract an important element of the overall profit in the transaction, thereby changing the lessor's net investment and the pattern of income recognition contemplated by the investment with separate phases method and thus, in the Board's view, rendering the use of that method inappropriate.

### **Effective Date and Transition**

115. The Board considered three methods of transition in the application of the Statement:

- a. Retroactive application with restatement of prior period financial statements
- b. Retroactive application without restatement
- c. Prospective application

The first alternative maximizes comparability of a company's financial statements with those of other companies and with its own statements for prior periods. However, respondents expressed concern that it would require the accumulation of a considerable amount of information about existing and expired leases and that some companies might have problems relating to restrictive covenants in loan indentures and other contracts. In addition, it requires estimates that in some cases would be made with after-the-fact knowledge. The second alternative reduces

the problem of data accumulation but at the cost of impairing interperiod comparability of a company's financial statements before and after the date of retroactive application. Depending on the particular circumstances, it may or may not mitigate the possible problems relating to loan indenture covenants. The third alternative avoids most of the problems of the other two but would result in noncomparability of financial statements, both as among different companies and those of the same company for different periods, for years in the future.

116. While the majority of respondents favored prospective application, others strongly urged that the Statement be applied retroactively with restatement. The long period of time that would ensue before comparability would be achieved was given as the prime reason by those advocating retroactivity. Some preparers, on the other hand, cited problems involving loan indenture restrictions should the Statement require retroactive application. Some companies with large numbers of leases stated in their responses that the task of gathering the necessary data for retroactive application would be onerous as well as time consuming for existing leases, and that it would be more difficult, if not impossible, to obtain the information on expired leases necessary for restatement.

117. Included in the responses was the suggestion that a transition period be established during which companies would be given time both for the purpose of accumulating the necessary data for retroactive application and for taking steps toward resolving problems that might arise in connection with restrictive clauses in loan indentures or other agreements.

118. In considering these conflicting recommendations, the Board was sympathetic to the problems of data accumulation for companies with large numbers of leases and to the problems that some companies believe might be associated with indenture restrictions. On the other hand, the objections raised, particularly by users of financial statements, to the long period of noncomparability of financial statements that would be entailed by prospective application concerned the Board. The Board concluded that the use of a transition period at the end of which full retroactive application would be required would best meet the needs of users while at the same time giving significant recognition to the problems referred to by preparers.

119. The procedure adopted by the Board calls for immediate prospective application of the Statement

(see paragraph 48), with retroactive restatement required after a four-year transition period (see paragraph 49). Thus, companies that might have problems arising from loan indenture restrictions are given at least four full years in which, depending on the nature of the restrictions, resolution of such problems may be possible. Further, restatement is required for periods beginning before December 31, 1976 only to the extent that it is practicable (see paragraph 51), in recognition of the fact that some companies may be unable to obtain or reconstruct the necessary information about leases expiring in prior years. Finally, interim disclosures (see paragraph 50) are called for to facilitate comparability before retroactive application of the Statement is required; however, since the Board recognizes that the accumula-

tion of information to make such disclosures may require time, companies are given at least one full year before such disclosure is called for. Although the Board recognizes that the period of time provided for transition will not completely eliminate the problems of retroactive restatement, it believes that those problems will be alleviated under the method outlined above and that the benefit to be gained through comparability of financial statements is substantial.

120. Upon consideration of the relevant circumstances, the Board concluded that the interests of users of financial statements would be best served by making the statement effective for leasing transactions and lease agreement revisions entered into on or after January 1, 1977, as provided by paragraph 48.

## Appendix C

### ILLUSTRATIONS OF ACCOUNTING BY LESSEES AND LESSORS

121. This Appendix contains the following schedules illustrating the accounting requirements of this Statement as applied to a particular example (an automobile lease):

1. Lease example—terms and assumptions, Schedule 1
2. Computation of minimum lease payments (lessee and lessor) and lessor's computation of rate of interest implicit in the lease, Schedule 2
3. Classification of the lease, Schedule 3
4. Journal entries for the first month of the lease as well as for the disposition of the leased property at the end of the lease term, Schedule 4

#### SCHEDULE 1

##### Lease Example Terms and Assumptions

Lessor's cost of the leased property (automobile)	\$5,000
Fair value of the leased property at inception of the lease (1/1/77)	\$5,000
Estimated economic life of the leased property	5 years

Lease terms and assumptions: The lease has a fixed noncancelable term of 30 months, with a rental of \$135 payable at the beginning of each month. The lessee guarantees the residual value at the end of the 30-month lease term in the amount of \$2,000. The lessee is to receive any excess of sales price of property over the guaranteed amount at the end of the lease term. The lessee pays executory costs. The lease is renewable periodically based on a schedule of rentals and guarantees of the residual values decreasing over time. The rentals specified are deemed to be fair rentals (as distinct from bargain rentals), and the guarantees of the residual are expected to approximate realizable values. No investment tax credit is available.

The residual value at the end of the lease term is estimated to be \$2,000. The lessee depreciates his owned automobiles on a straight-line basis. The lessee's incremental borrowing rate is 10½% per year. There were no initial direct costs of negotiating and closing the transaction. At the end of the lease the asset is sold for \$2,100.

## Accounting for Leases

### SCHEDULE 2

#### Computation of Minimum Lease Payments (Lessee and Lessor)

In accordance with paragraph 5(j), minimum lease payments for both the lessee and lessor are computed as follows:

Minimum rental payments over the lease term ( $\$135 \times 30$ months)	\$4,050
Lessee guarantee of the residual value at the end of the lease term	<u>2,000</u>
Total minimum lease payments	<u><u>\$6,050</u></u>

#### Lessor's Computation of Rate of Interest Implicit in the Lease

In accordance with paragraph 5(k), the interest rate implicit in the lease is that rate implicit in the recovery of the fair value of the property at the inception of the lease (\$5,000) through the minimum lease payments (30 monthly payments of \$135 and the lessee's guarantee of the residual value in the amount of \$2,000 at the end of the lease term). That rate is 12.036% (1.003% per month).

### SCHEDULE 3

#### Classification of the Lease

##### Criteria set forth in paragraph

- |      |   |
|------|---|
| 7(a) | <i>Not met.</i> The lease does not transfer ownership of the property to the lessee by the end of the least term.   |
| 7(b) | <i>Not met.</i> The lease does not contain a bargain purchase option.   |
| 7(c) | <i>Not met.</i> The lease term is not equal to 75% or more of the estimated economic life of the property. (In this case, it represents only 50% of the estimated economic life of the property.)   |
| 7(d) | <i>Met.</i> In the lessee's case, the present value (\$5,120) of the minimum lease payments using his incremental borrowing rate (10½%) exceeds 90% of the fair value of the property at the inception of the lease. (See computation below.) Even if the lessee knows the implicit rate, he uses his incremental rate because it is lower. The lessee classifies the lease as a capital lease. In the lessor's case, the present value (\$5,000) of the minimum lease payments using the implicit rate also exceeds 90% of the fair value of the property. (See computation below.) Having met this criterion and assuming that the criteria of paragraph 8 are also met, the lessor will classify the lease as a direct financing lease (as opposed to a sales-type lease) because the cost and fair value of the asset are the same at the inception of the lease. (See paragraph 6(b)(ii).) |

	<b>Present Values</b>	
	<b>Lessee's computation using his incremental borrowing rate of 10½% (.875% per month)*</b>	<b>Lessor's computation using the implicit interest rate of 12.036% (1.003% per month)</b>
Minimum lease payments:		
Rental payments	\$3,580	\$3,517
Residual guarantee by lessee	1,540	1,483
Total	<u>\$5,120</u>	<u>\$5,000</u>
Fair value of the property at inception of the lease	<u>\$5,000</u>	<u>\$5,000</u>
Minimum lease payments as a percentage of fair value	<u>102%</u>	<u>100%</u>

\*In this case, the lessee's incremental borrowing rate is used because it is lower than the implicit rate. (See paragraph 7(d).)

#### SCHEDULE 4

#### Journal Entries for the First Month of the Lease as Well as for the Disposition of the Leased Property at the End of the Lease Term

##### First Month of the Lease

###### LESSEE

1/1/77	Leased property under capital leases	5,000	
	Obligations under capital leases		5,000
	To record capital leases at the fair value of the property. (Since the present value of the minimum lease payments using the lessee's incremental borrowing rate as the discount rate (see paragraph 7(d) for selection of rate to be used) is greater than the fair value of the property, the lessee capitalizes only the fair value of the property. (See paragraph 10.))		
1/1/77	Obligations under capital leases	135	
	Cash		135
	To record first month's rental payment.		
1/31/77	Interest expense	49	
	Accrued interest on obligations under capital leases		49*
	To recognize interest expense for the first month of the lease. Obligation balance outstanding during month \$4,865 ( $\$5,000 - \$135$ ) $\times$ 1.003% (rate implicit in the liquidation of the \$5,000 obligation through (a) 30 monthly payments of \$135 made at the beginning of each month and (b) a \$2,000 guarantee of the residual value at the end of 30 months) = \$49. (See paragraph 12.)		

\*In accordance with paragraph 12, the February 1, 1977 rental payment of \$135 will be allocated as follows: \$86 (principal reduction) against obligations under capital leases and \$49 against accrued interest on obligations under capital leases.

*Accounting for Leases*

1/31/77	Depreciation expense	100	
	Leased property under capital leases		100
	To record first month's depreciation on a straight-line basis over 30 months to a salvage value of \$2,000, which is the estimated residual value to the lessee. (See paragraph 11(b).)		
LESSOR			
1/1/77	Minimum lease payments receivable	6,050	
	Automobile		5,000
	Unearned income		1,050
	To record lessor's investment in the direct financing lease. (See paragraphs 18(a) and (b).)		
1/1/77	Cash	135	
	Minimum lease payments receivable		135
	To record receipt of first month's rental payment under the lease.		
1/31/77	Unearned income	49	
	Earned income		49
	To recognize the portion of unearned income that is earned during the first month of the lease. Net investment outstanding for month \$4,865 (gross investment \$5,915 (\$6,050 – \$135) less unearned income (\$1,050) × 1.003% (monthly implicit rate in the lease) = \$49. (See paragraph 18(b).)		
Disposition of Asset for \$2,100			
LESSEE			
7/1/79	Cash	100	
	Obligations under capital leases	1,980	
	Accrued interest on obligations under capital leases	20	
	Leased property under capital leases		2,000
	Gain on disposition of leased property		100
	To record the liquidation of the obligations under capital leases and receipt of cash in excess of the residual guarantee through the sale of the leased property.		
LESSOR			
7/1/79	Cash	2,000	
	Minimum lease payments receivable		2,000
	To record the receipt of the amount of the lessee's guarantee.		



**Note to Disposition of Asset**

Had the lessee elected at July 1, 1979 to renew the lease, it would render inoperative the guarantee as of that date. For that reason, the renewal would not be treated as a new agreement, as would otherwise be the case under paragraph 9, but would instead be accounted for as provided in paragraph 12. The lessee would accordingly adjust the remaining balances of the asset and obligation from the original lease, which at June 30, 1979 were equal, by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the remaining balance of the obligation. The present value of the future minimum lease payments would be computed using the rate of interest used to record the lease initially.

From the lessor's standpoint, the revised agreement would be accounted for in accordance with para-

graph 17(e). Accordingly, the remaining balance of minimum lease payments receivable would be adjusted to the amount of the payments called for by the revised agreement, and the adjustment would be credited to unearned income.

**Appendix D****ILLUSTRATIONS OF DISCLOSURE BY LESSEES AND LESSORS**

122. This Appendix illustrates one way of meeting the disclosure requirements of this Statement, except for those relating to leveraged leases which are illustrated in Appendix E. The illustrations do not encompass all types of leasing arrangements for which disclosures are required. For convenience, the illustrations have been constructed as if the Statement had been in effect in prior years.

**LESSEE'S DISCLOSURE****Company X  
BALANCE SHEET**

<u>ASSETS</u>		<u>LIABILITIES</u>	
	<u>December 31,</u> <u>1976</u> <u>1975</u>		<u>December 31,</u> <u>1976</u> <u>1975</u>
Leased property under capital leases, less accumulated amortization (Note 2)	XXX    XXX	Current:	
		Obligations under capital leases (Note 2)	XXX    XXX
		Noncurrent:	
		Obligations under capital leases (Note 2)	XXX    XXX

Footnotes appear on the following pages.

## Accounting for Leases

### FOOTNOTES

#### Note 1—Description of Leasing Arrangements

The Company conducts a major part of its operations from leased facilities which include a manufacturing plant, 4 warehouses, and 26 stores. The plant lease, which is for 40 years expiring in 1999, is classified as a capital lease. The warehouses are under operating leases that expire over the next 7 years. Most of the leases of store facilities are classified as capital leases. All of the leases of store facilities expire over the next 15 years.

Most of the operating leases for warehouses and store facilities contain one of the following options: (a) the Company can, after the initial lease term, purchase the property at the then fair value of the property or (b) the Company can, at the end of the initial lease term, renew its lease at the then fair rental value for periods of 5 to 10 years. These options enable the Company to retain use of facilities in desirable operating areas. The rental payments under a store facility lease are based on a minimum rental plus a percentage of the store's sales in excess of stipulated

amounts. Portions of store space and warehouse space are sublet under leases expiring during the next 5 years.

In addition, the Company leases transportation equipment (principally trucks) and data processing equipment under operating leases expiring during the next 3 years.

In most cases, management expects that in the normal course of business, leases will be renewed or replaced by other leases.

The plant lease prohibits the Company from entering into future lease agreements if, as a result of new lease agreements, aggregate annual rentals under all leases will exceed \$XXX.

#### Note 2—Capital Leases

The following is an analysis of the leased property under capital leases by major classes:

Classes of Property	Asset Balances at December 31,	
	1976	1975
Manufacturing	\$ XXX	\$ XXX
Store facilities	XXX	XXX
Other	XXX	XXX
Less: Accumulated amortization	(XXX)	(XXX)
	<u>\$ XXX</u>	<u>\$ XXX</u>

## FAS13

## FASB Statement of Standards

The following is a schedule by years of future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of December 31, 1976:

Year ending December 31:	
1977	\$ XXX
1978	XXX
1979	XXX
1980	XXX
1981	XXX
Later years	XXX
Total minimum lease payments <sup>1</sup>	XXX
Less: Amount representing estimated executory costs (such as taxes, maintenance, and insurance), including profit thereon, included in total minimum lease payments	(XXX)
Net minimum lease payments	XXX
Less: Amount representing interest <sup>2</sup>	(XXX)
Present value of net minimum lease payments <sup>3</sup>	\$ XXX

<sup>1</sup>Minimum payments have not been reduced by minimum sublease rentals of \$XXX due in the future under noncancelable subleases. They also do not include contingent rentals which may be paid under certain store leases on the basis of a percentage of sales in excess of stipulated amounts. Contingent rentals amounted to \$XXX in 1976 and \$XXX in 1975.

<sup>2</sup>Amount necessary to reduce net minimum lease payments to present value calculated at the Company's incremental borrowing rate at the inception of the leases.

<sup>3</sup>Reflected in the balance sheet as current and noncurrent obligations under capital leases of \$XXX and \$XXX, respectively.

### Note 3—Operating Leases

The following is a schedule by years of future minimum rental payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of December 31, 1976:

Year ending December 31:	
1977	\$XXX
1978	XXX
1979	XXX
1980	XXX
1971	XXX
Later years	XXX
Total minimum payments required*	\$XXX

\*Minimum payments have not been reduced by minimum sublease rentals of \$XXX due in the future under noncancelable subleases.

The following schedule shows the composition of total rental expense for all operating leases except those with terms of a month or less that were not renewed:

	Year ending December 31,	
	1976	1975
Minimum rentals	\$ XXX	\$ XXX
Contingent rentals	XXX	XXX
Less: Sublease rentals	(XXX)	(XXX)
	\$ XXX	\$ XXX

*Accounting for Leases*

**LESSOR'S DISCLOSURE (Other Than for Leveraged Leases)**

**Company X  
BALANCE SHEET**

	<b>December 31,</b>	
<b>ASSETS</b>	<b>1976</b>	<b>1975</b>
Current assets:		
Net investment in direct financing and sales-type leases (Note 2)	XXX	XXX
Noncurrent assets:		
Net investment in direct financing and sales-type leases (Note 2)	XXX	XXX
Property on operating leases and property held for leases (net of accumulated depreciation of \$XXX and \$XXX for 1976 and 1975, respectively) (Note 3)	XXX	XXX

Footnotes appear [below and] on the following pages.

**FOOTNOTES**

**Note 1—Description of Leasing Arrangements**

The Company's leasing operations consist principally of the leasing of various types of heavy construction and mining equipment, data processing equipment, and transportation equipment. With the exception of the leases of transportation equipment, the bulk of the Company's leases are classified as direct financing leases. The construction equipment and mining equipment leases expire over the next ten

years and the data processing equipment leases expire over the next eight years. Transportation equipment (principally trucks) is leased under operating leases that expire during the next three years.

**Note 2—Net Investment in Direct Financing and Sales-Type Leases**

The following lists the components of the net investment in direct financing and sales-type leases as of December 31:

	<b>1976</b>	<b>1975</b>
Total minimum lease payments to be received*	\$ XXX	\$ XXX
Less: Amounts representing estimated executory costs (such as taxes, maintenance, and insurance), including profit thereon, included in total minimum lease payments	(XXX)	(XXX)
Minimum lease payments receivable	XXX	XXX
Less: Allowance for uncollectibles	(XXX)	(XXX)
Net minimum lease payments receivable	XXX	XXX
Estimated residual values of leased property (unguaranteed)	XXX	XXX
Less: Unearned income	(XXX)	(XXX)
Net investment in direct financing and sales-type leases	<u>\$ XXX</u>	<u>\$ XXX</u>

\*Minimum lease payments do not include contingent rentals which may be received under certain leases of data processing equipment on the basis of hours of use in excess of stipulated minimums. Contingent rentals amounted to \$XXX in 1976 and \$XXX in 1975. At December 31, 1976, minimum lease payments for each of the five succeeding fiscal years are as follows: \$XXX in 1977, \$XXX in 1978, \$XXX in 1979, \$XXX in 1980, and \$XXX in 1981.

**Note 3—Property on Operating Leases and Property Held for Lease**

The following schedule provides an analysis of the Company's investment in property on operating leases and property held for lease by major classes as of December 31, 1976:

Construction equipment	\$ XXX
Mining equipment	XXX
Data processing equipment	XXX
Transportation equipment	XXX
Other	XXX
	<u>XXX</u>
Less: Accumulated depreciation	(XXX)
	<u>\$ XXX</u>

**Note 4—Rentals under Operating Leases**

The following is a schedule by years of minimum future rentals on noncancelable operating leases as of December 31, 1976:

Year ending December 31:	
1977	\$XXX
1978	XXX
1979	XXX
1980	XXX
1981	XXX
Later years	XXX
Total minimum future rentals*	<u>\$XXX</u>

\*This amount does not include contingent rentals which may be received under certain leases of data processing equipment on the basis of hours of use in excess of stipulated minimums. Contingent rentals amounted to \$XXX in 1976 and \$XXX in 1975.

**Appendix E****ILLUSTRATIONS OF ACCOUNTING AND FINANCIAL STATEMENT PRESENTATION FOR LEVERAGED LEASES**

123. This Appendix illustrates the accounting requirements of this Statement and one way of meeting its disclosure requirements as applied to a leveraged lease. The illustrations do not encompass all circumstances that may arise in connection with leveraged leases; rather, the illustrations are based on a single example of a leveraged lease, the terms and assumptions for which are stated in Schedule 1. The elements of accounting and reporting illustrated for this example of a leveraged lease are as follows:

a. Leveraged lease example—terms and assumptions, Schedule 1

- b. Cash flow analysis by years, Schedule 2
- c. Allocation of annual cash flow to investment and income, Schedule 3
- d. Journal entries for lessor's initial investment and first year of operation, Schedule 4
- e. Financial statements including footnotes at end of second year
- f. Accounting for a revision in the estimated residual value of the leased asset assumed to occur in the eleventh year of the lease (from \$200,000 to \$120,000):
  - i. Revised allocation of annual cash flow to investment and income, Schedule 5
  - ii. Balances in investment accounts at beginning of the eleventh year before revised estimate, Schedule 6
  - iii. Journal entries, Schedule 7
  - iv. Adjustment of investment accounts, Schedule 8



*Accounting for Leases*

**SCHEDULE 1**

**Leveraged Lease Example  
Terms and Assumptions**

Cost of leased asset (equipment)	\$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	\$90,000 per year (payable last day of each year)
Residual value	\$200,000 estimated to be realized one year after lease termination. In the eleventh year of the lease the estimate is reduced to 120,000.
Financing:	
Equity investment by lessor	\$400,000
Long-term nonrecourse debt	\$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of \$74,435.30
Depreciation allowable to lessor for income tax purposes	Seven-year ADR life using double-declining-balance method for the first two years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to \$100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or \$100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration.

## SCHEDULE 2

## Cash Flow Analysis by Years

Year	1	2	3	4	5	6	7	8	9
	Gross lease rentals and residual value	Depreciation (for income tax purposes)	Loan interest payments	Taxable income (loss) (col. 1 - 2 - 3)	Income tax credits (charges) (col. 4 × 50.4%)	Loan principal payments	Investment tax credit realized	Annual cash flow (col. 1 - 3 + 5 - 6 + 7)	Cumulative cash flow
Initial investment	—	—	—	—	—	—	—	\$(400,000)	\$(400,000)
1	\$ 90,000	\$ 142,857	\$ 54,000	\$(106,857)	\$ 53,856	\$ 20,435	\$100,000	169,421	(230,579)
2	90,000	244,898	52,161	(207,059)	104,358	22,274	—	119,923	(110,656)
3	90,000	187,075	50,156	(147,231)	74,204	24,279	—	89,769	(20,887)
4	90,000	153,061	47,971	(111,032)	55,960	26,464	—	71,525	50,638
5	90,000	119,048	45,589	(74,637)	37,617	28,846	—	53,182	103,820
6	90,000	53,061	42,993	(6,054)	3,051	31,442	—	18,616	122,436
7	90,000	—	40,163	49,837	(25,118)	34,272	—	(9,553)	112,883
8	90,000	—	37,079	52,921	(26,672)	37,357	—	(11,108)	101,775
9	90,000	—	33,717	56,283	(28,367)	40,719	—	(12,803)	88,972
10	90,000	—	30,052	59,948	(30,214)	44,383	—	(14,649)	74,323
11	90,000	—	26,058	63,942	(32,227)	48,378	—	(16,663)	57,660
12	90,000	—	21,704	68,296	(34,421)	52,732	—	(18,857)	38,803
13	90,000	—	16,957	73,043	(36,813)	57,478	—	(21,248)	17,555
14	90,000	—	11,785	78,215	(39,420)	62,651	—	(23,856)	(6,301)
15	90,000	—	6,145	83,855	(42,263)	68,290	—	(26,698)	(32,999)
16	200,000	100,000	—	100,000	(50,400)	—	—	149,600	116,601
Totals	\$1,550,000	\$1,000,000	\$516,530	\$ 33,470	\$ (16,869)	\$600,000	\$100,000	116,601	

*Accounting for Leases*

**SCHEDULE 3**

**Allocation of Annual Cash Flow to Investment and Income**

Year	1	Annual Cash Flow			Components of Income <sup>2</sup>		
		2	3	4	5	6	7
	Lessor's net investment at beginning of year	Total (from Schedule 2, col. 8)	Allocated to investment	Allocated to income <sup>1</sup>	Pretax income	Tax effect of pretax income	Investment tax credit
1	\$400,000	\$169,421	\$134,833	\$ 34,588	\$ 9,929	\$ (5,004)	\$ 29,663
2	265,167	119,923	96,994	22,929	6,582	(3,317)	19,664
3	168,173	89,769	75,227	14,542	4,174	(2,104)	12,472
4	92,946	71,525	63,488	8,037	2,307	(1,163)	6,893
5	29,458	53,182	50,635	2,547	731	(368)	2,184
6	(21,177)	18,616	18,616	—	—	—	—
7	(39,793)	(9,553)	(9,553)	—	—	—	—
8	(30,240)	(11,108)	(11,108)	—	—	—	—
9	(19,132)	(12,803)	(12,803)	—	—	—	—
10	(6,329)	(14,649)	(14,649)	—	—	—	—
11	8,320	(16,663)	(17,382)	719	206	(104)	617
12	25,702	(18,857)	(21,079)	2,222	637	(321)	1,906
13	46,781	(21,248)	(25,293)	4,045	1,161	(585)	3,469
14	72,074	(23,856)	(30,088)	6,232	1,789	(902)	5,345
15	102,162	(26,698)	(35,532)	8,834	2,536	(1,278)	7,576
16	137,694	149,600	137,694	11,906	3,418	(1,723)	10,211
Totals		\$516,601	\$400,000	\$116,601	\$33,470	\$ (16,869)	\$100,000

<sup>1</sup> Lease income is recognized as 8.647% of the unrecovered investment at the beginning of each year in which the net investment is positive. 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 (net cash flow) to those years. The rate for allocation used in this Schedule is calculated by a trial and error process. The allocation is calculated based upon an initial estimate of the rate as a starting point. If the total thus allocated to income (column 4) differs under the estimated rate from the net cash flow (Schedule 2, column 8) the estimated rate is increased or decreased, as appropriate, to derive a revised allocation. This process is repeated until a rate is selected which develops a total amount allocated to income that is precisely equal to the net cash flow. As a practical matter, a computer program is used to calculate Schedule 3 under successive iterations until the correct rate is determined.

<sup>2</sup>Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4.

## FAS13

## FASB Statement of Standards

**SCHEDULE 4****Illustrative Journal Entries for Year Ending December 31, 1975**Lessor's Initial Investment

Rentals receivable (Schedule 2, total of column 1 less residual value, less totals of columns 3 and 6)	233,470	
Investment tax credit receivable (Schedule 2, column 7)	100,000	
Estimated residual value (Schedule 1)	200,000	
Unearned and deferred income (Schedule 3, totals of columns 5 and 7)		133,470
Cash		400,000
Record lessor's initial investment		

First Year of Operation*Journal Entry 1*

Cash	15,565	
Rentals receivable (Schedule 2, column 1 less columns 3 and 6)		15,565
Collection of first year's net rental		

*Journal Entry 2*

Cash*	100,000	
Investment tax credit receivable (Schedule 2, column 7)		100,000
Receipt of investment tax credit		

*Journal Entry 3*

Unearned and deferred income	9,929	
Income from leveraged leases (Schedule 3, column 5)		9,929
Recognition of first year's portion of pretax income allocated in the same proportion as the allocation of total income		
$\left( \frac{34,588}{116,601} \right) \times 33,470 = 9,929$		

*Journal Entry 4*

Unearned and deferred income	29,663	
Investment tax credit recognized (Schedule 3, column 7)		29,663
Recognition of first year's portion of investment tax credit allocated in the same proportion as the allocation of total income		
$\left( \frac{34,588}{116,601} \right) \times 100,000 = 29,663$		

*Journal Entry 5*

Cash (Schedule 2, column 5)*	53,856	
Income tax expense (Schedule 3, column 6)	5,004	
Deferred taxes		58,860
To record receipt of first year's tax credit from lease operation, to charge income tax expense for tax effect of pretax accounting income, and to recognize as deferred taxes the tax effect of the difference between pretax accounting income and the tax loss for the year, calculated as follows:		
Tax loss (Schedule 2, column 4)	\$(106,857)	
Pretax accounting income	9,929	
Difference	<u>\$(116,786)</u>	
Deferred taxes $(\$116,786 \times 50.4\%)$	<u>\$ 58,860</u>	

\*Receipts of the investment tax credit and other tax benefits are shown as cash receipts for simplicity only. Those receipts probably would not be in the form of immediate cash inflow. Instead, they likely would be in the form of reduced payments of taxes on other income of the lessor or on the combined income of the lessor and other entities whose operations are joined with the lessor's operations in a consolidated tax return.

*Accounting for Leases*

**ILLUSTRATIVE PARTIAL FINANCIAL  
STATEMENTS INCLUDING FOOTNOTES**

**BALANCE SHEET**

<u>ASSETS</u>		<u>LIABILITIES</u>	
<u>December 31,</u>		<u>December 31,</u>	
<u>1976</u>	<u>1975</u>	<u>1976</u>	<u>1975</u>
Investment in leveraged leases	\$334,708    \$324,027	Deferred taxes arising from leveraged leases	\$166,535    \$58,860

**INCOME STATEMENT**

(Ignoring all income and expense items other than those relating to leveraged leasing)

	<u>1976</u>	<u>1975</u>
Income from leveraged leases	\$ 6,582	\$ 9,929
Income before taxes and investment tax credit	6,582	9,929
Less: Income tax expense*	(3,317)	(5,004)
	3,265	4,925
Investment tax credit recognized*	19,664	29,663
Net income	<u>\$22,929</u>	<u>\$34,588</u>

\*These two items may be netted for purposes of presentation in the income statement, provided that the separate amounts are disclosed in a note to the financial statements.

Footnotes appear [below and] on the following page.

**FOOTNOTES**

**Investment in Leveraged Leases**

The Company is the lessor in a leveraged lease agreement entered into in 1975 under which mining equipment having an estimated economic life of 18 years was leased for a term of 15 years. The Company's equity investment represented 40 percent of the purchase price; the remaining 60 percent was furnished by third-party financing in the form of long-term debt that provides for no recourse against the Company and is secured by a first lien on the property. At

the end of the lease term, the equipment is turned back to the Company. The residual value at that time is estimated to be 20 percent of cost. For federal income tax purposes, the Company receives the investment tax credit and has the benefit of tax deductions for depreciation on the entire leased asset and for interest on the long-term debt. Since during the early years of the lease those deductions exceed the lease rental income, substantial excess deductions are available to be applied against the Company's other income. In the later years of the lease, rental income will exceed the deductions and taxes will be payable. Deferred taxes are provided to reflect this reversal.



## FAS13

## FASB Statement of Standards

The Company's net investment in leveraged leases is composed of the following elements:

	<b>December 31,</b>	
	<b><u>1976</u></b>	<b><u>1975</u></b>
Rentals receivable (net of principal and interest on the nonrecourse debt)	\$ 202,340	\$217,905
Estimated residual value of leased assets	200,000	200,000
Less: Unearned and deferred income	<u>(67,632)</u>	<u>(93,878)</u>
Investment in leveraged leases	334,708	324,027
Less: Deferred taxes arising from leveraged leases	<u>(166,535)</u>	<u>(58,860)</u>
Net investment in leveraged leases	<u><u>\$ 168,173</u></u>	<u><u>\$265,167</u></u>

**SCHEDULE 5**

**Allocation of Annual Cash Flow to Investment and Income  
Revised to Include New Residual Value Estimate**

	1	2	3	4	5	6	7
		Annual Cash Flow			Components of Income		
Year	Lessor's net investment at beginning of year	Total	Allocated to investment	Allocated to income <sup>1</sup>	Pretax loss	Tax effect of pretax loss	Investment tax credit
1	\$400,000	\$169,421	\$142,458	\$26,963	\$(16,309)	\$ 8,220	\$ 35,052
2	257,542	119,923	102,563	17,360	(10,501)	5,293	22,568
3	154,979	89,769	79,323	10,446	(6,319)	3,184	13,581
4	75,656	71,525	66,425	5,100	(3,085)	1,555	6,630
5	9,231	53,182	52,560	622	(377)	190	809
6	(43,329)	18,616	18,616	—	—	—	—
7	(61,945)	(9,553)	(9,553)	—	—	—	—
8	(52,392)	(11,108)	(11,108)	—	—	—	—
9	(41,284)	(12,803)	(12,803)	—	—	—	—
10	(28,481)	(14,649)	(14,649)	—	—	—	—
11	(13,832)	(16,663)	(16,663)	—	—	—	—
12	2,831	(18,857)	(19,048)	191	(115)	58	248
13	21,879	(21,248)	(22,723)	1,475	(892)	450	1,917
14	44,602	(23,856)	(26,862)	3,006	(1,819)	916	3,909
15	71,464	(26,698)	(31,515)	4,817	(2,914)	1,469	6,262
16	102,979	109,920	102,979	6,941	(4,199)	2,116	9,024
Totals		<u>\$476,921</u>	<u>\$400,000</u>	<u>\$76,921</u>	<u>\$(46,530)</u>	<u>\$23,451</u>	<u>\$100,000</u>

<sup>1</sup>The revised allocation rate is 6.741%.

**SCHEDULE 6**

**Balances in Investment Accounts before Revised Estimate of Residual Value**

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>
				<b>Unearned &amp; Deferred Income</b>			
	<b>Rentals receivable<sup>1</sup></b>	<b>Estimated residual value</b>	<b>Investment tax credit receivable</b>	<b>Pretax income (loss)<sup>2</sup></b>	<b>Investment tax credit<sup>3</sup></b>	<b>Deferred taxes<sup>4</sup></b>	<b>Net investment (col. 1 + 2 + 3) less (col. 4 + 5 + 6)</b>
Initial investment	\$233,470	\$200,000	\$ 100,000	\$33,470	\$100,000	\$ —	\$ 400,000
Changes in year of operation							
1	(15,565)	—	(100,000)	(9,929)	(29,663)	58,860	(134,833)
2	(15,565)	—	—	(6,582)	(19,664)	107,675	(96,994)
3	(15,565)	—	—	(4,174)	(12,472)	76,308	(75,227)
4	(15,565)	—	—	(2,307)	(6,893)	57,123	(63,488)
5	(15,565)	—	—	(731)	(2,184)	37,985	(50,635)
6	(15,565)	—	—	—	—	3,051	(18,616)
7	(15,565)	—	—	—	—	(25,118)	9,553
8	(15,564)	—	—	—	—	(26,672)	11,108
9	(15,564)	—	—	—	—	(28,367)	12,803
10	(15,565)	—	—	—	—	(30,214)	14,649
Balances, beginning of eleventh year	<u>\$ 77,822</u>	<u>200,000</u>	<u>\$ —</u>	<u>\$ 9,747</u>	<u>\$ 29,124</u>	<u>\$230,631</u>	<u>\$ 8,320</u>

<sup>1</sup>Schedule 2, column 1, excluding residual value, less columns 3 and 6.

<sup>2</sup>Schedule 3, column 5.

<sup>3</sup>Schedule 3, column 7.

<sup>4</sup>50.4% of difference between taxable income (loss), Schedule 2, column 4, and pretax accounting income (loss), Schedule 3, column 5.

**SCHEDULE 7****Illustrative Journal Entries  
Reduction in Residual Value in Eleventh Year**

<i>Journal Entry 1</i>		
Pretax income (or loss)		60,314
Unearned and deferred income		27,450
Pretax income (loss):		
Balance at end of 10th year	9,747 <sup>1</sup>	
Revised balance	(9,939) <sup>2</sup>	
Adjustment	(19,686)	
Deferred investment tax credit:		
Balance at end of 10th year	29,124 <sup>3</sup>	
Revised balance	21,360 <sup>4</sup>	
Adjustment	(7,764)	
Investment tax credit recognized		7,764
Estimated residual value		80,000
To record:		
i. The cumulative effect on pretax income and the effect on future income resulting from the decrease in estimated residual value:		
Reduction in estimated residual value		\$ 80,000
Less portion attributable to future years (unearned and deferred income)		(19,686)
Cumulative effect (charged against current income)		<u>\$ 60,314</u>
ii. The cumulative and future effect of the change in allocation of the investment tax credit resulting from the reduction in estimated residual value		
<i>Journal Entry 2</i>		
Deferred taxes	30,398	
Income tax expense		30,398
To recognize deferred taxes for the difference between pretax accounting income (or loss) and taxable income (or loss) for the effect of the reduction in estimated residual value.		
Pretax accounting loss per journal entry 1	\$(60,314)	
Tax income (or loss)	—	
Difference	<u>\$(60,314)</u>	
Deferred taxes (\$60,314 × 50.4%)	<u>\$(30,398)</u>	

<sup>1</sup>Schedule 6, column 4.<sup>2</sup>Schedule 5, total of column 5 less amounts applicable to the first 10 years.<sup>3</sup>Schedule 6, column 5.<sup>4</sup>Schedule 5, total of column 7 less amounts applicable to the first 10 years.

**SCHEDULE 8**

**Adjustment of Investment Accounts for Revised  
Estimate of Residual Value in Eleventh Year**

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>
			<b>Unearned &amp; Deferred Income</b>			<b>Net investment</b>
	<b>Rentals receivable</b>	<b>Estimated residual value</b>	<b>Pretax income (loss)</b>	<b>Investment tax credit</b>	<b>Deferred taxes</b>	<b>(col. 1 + 2) less (col. 3 + 4 + 5)</b>
Balances, beginning of eleventh year (Schedule 6)	\$77,822	\$200,000	\$ 9,747	\$29,124	\$230,631	\$ 8,320
Adjustment of estimated residual value and unearned and deferred income (Schedule 7—journal entry 1)	—	(80,000)	(19,686)	(7,764)	—	(52,550)
Adjustment of deferred taxes for the cumulative effect on pretax accounting income (Schedule 7—journal entry 2)	—	—	—	—	(30,398)	30,398
Adjusted balances, beginning of eleventh year	<u>\$77,822</u>	<u>\$120,000</u>	<u>\$ (9,939)</u>	<u>\$21,360</u>	<u>\$200,233</u>	<u>\$ (13,832)<sup>1</sup></u>

<sup>1</sup>Schedule 5, column 1.