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Accounting for leases; responses to issues raised in FASB Discussion memorandum, July 2, 1974 (FASB file reference 1002); Statement of position 74-10;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position on

74-10

Accounting for Leases

October 11, 1974

Responses to Issues Raised in FASB Discussion Memorandum, July 2, 1974 (FASB File Reference 1002)

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

Notes

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING FOR LEASES

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has considered the Discussion Memorandum, Accounting for Leases, dated July 2, 1974, and has formulated on behalf of the Accounting Standards Division this Statement of Position on the issues raised in that document.

MAJOR CONCLUSIONS

The major conclusions of the Division on the principal issues raised in the Discussion Memorandum are as follows:

1. The determination of whether a lease should be capitalized in the financial statements of the lessee should be based on whether the lease is in substance an installment purchase.

2. If any one of the following criteria are met, the lease should be considered to be in substance an installment purchase by the lessee.

    a. The lessee builds up a material equity in the leased property.

    b. The lease term approximates the estimated useful life of the property (i.e., the term is equal to 75% or more of the estimated useful life of the property).

    c. The lessee guarantees directly the lessors' debt on the leased property and such debt is substantial in relation to the cost of the property.

    d. The lease passes the usual risks and rewards of ownership to the lessee.

    e. The residual value of the property at the end of the lease is expected to be nominal.

f. The lease agreement provides that the lessor will recover his investment plus a fair return.

The existence of other criteria discussed under Implemental Issue One should be considered to be suggestive (not conclusive) evidence that a lease transaction is in substance an installment purchase.

3. The same criteria which are used to determine whether a lease should be treated as an installment purchase by a lessee generally should also be used to determine whether a lessor should treat the transaction as a sale or a loan. However, the retention of some risks by a lessor/sellor may necessitate deferral of some or all of the profit on the sale.

4. Capitalized lease assets and obligations should be accounted for in the same manner as owned assets and legal debt and, therefore, the accounting for such leases would ordinarily result in a different effect on net income from that which would result from the pattern of lease rental payments.

5. Income from leveraged leases should be accounted for under the three-party financing lease concept.

A significant minority of the Accounting Standards Executive Committee, it should be noted, favors the capitalization of all lease obligations on the premise that the acquisition, through a lease, of an intangible property right gives rise to a recordable asset and obligation of the lessee.

LESSEE ACCOUNTING -- BASIC ISSUES

BASIC ISSUE ONE:

> Should leases which are in substance installment purchases be capitalized?

Leases which are in substance installment purchases should be capitalized by lessees. Implemental criteria for distinguishing installment purchases from other leases are discussed later in this Statement of Position under Implemental Issue One. The Division's conclusion is based on the view that the inclusion of such leased assets and obligations among the assets and liabilities of the entity more clearly reports their economic substance and more usefully presents the financial position of the lessee.

BASIC ISSUE TWO:

> Should leasing agreements whose terms give rise to debt in the strict legal sense be recorded as liabilities?

Leasing agreements whose terms give rise to debt in a strict legal sense should be recorded as liabilities in the financial statements of the lessee. Absence of debt in the strict legal sense, however, should not preclude capitalization if other criteria are met.

If capitalization of leases is to be based solely on their legal status, the Board should give careful consideration to the fact that laws on contracts differ from state to state and it would be impossible to achieve comparable results.

BASIC ISSUE THREE:

> How should leases which are not in substance installment purchases and which do not give rise to legal debt be treated?

Leases which are not in substance installment purchases and leases which do not give rise to legal debt should not be capitalized. However, a significant minority of the Accounting Standards Executive Committee believes that such leases should be capitalized since each gives rise to the acquisition, through a lease, of an intangible property right which is an important economic resource of the entity, and of a lease obligation which is an important economic obligation of the entity.

BASIC ISSUE FOUR:

> If leases are capitalized, should the effect on net income differ from that otherwise resulting from the pattern of lease rental payments?

Capitalized leased assets and obligations should be accounted for in the same manner as owned assets and legal debt and, therefore, the accounting for such leases would ordinarily result in a different effect on net income from that which would result from the pattern of lease rental payments.

BASIC ISSUE FIVE:

> Does footnote disclosure represent a satisfactory alternative to lease capitalization in fulfilling users' needs for information concerning leasing transactions?

No, since it does not result in a presentation of acquired property and incurred obligations in a manner which most clearly reflects their economic substance.

BASIC ISSUE SIX:

> Assuming no change in present requirements for capitalization of leases, should disclosure of the present values be required for certain noncapitalized lease commitments and, if so, what types of leases should be included in the calculation?

If there is no change in present requirements for capitalization of leases, disclosure of the present values of noncapitalized leases which are in substance installment purchases should be included in the notes to financial statements. For this purpose, such calculation should include all leases which are not capitalized in the financial statements but which meet the criteria set forth in the response to Implemental Issue One.

A minority of the Accounting Standards Executive Committee favors disclosure of the present value of all noncapitalized leases.

BASIC ISSUE SEVEN:

> Should disclosure of the effect on net income had the leases referred to in Basic Issue Six been capitalized be required?

No, since there would be no purpose in disclosing the effect on net income of a method of accounting not required by the Board.

BASIC ISSUE EIGHT:

> If some leases are capitalized, does this obviate the need for disclosing information in footnotes concerning those leases?

No, but information in footnotes concerning capitalized leases may be limited to that information which is required to be disclosed for owned assets and long-term debt and other information required due to terms which are unique to lease arrangements.

BASIC ISSUE NINE:

> Should Accounting for leases by lessees and lessors be symmetrical?

Accounting for leases by lessees and lessors should be "symmetrical" in the sense that the criteria which determine whether the lessee has a lease obligation which should be capitalized should also determine whether the lessor has a lease receivable. The Division does not believe that the lessor's recognition of a receivable in a lease transaction by a manufacturer or dealer implies that a profit should be recognized immediately, nor does it believe that the accounting by either the lessor or the lessee should be predicated upon the accounting performed by the other party to the transaction, since the implementation of such a standard would not be practicable.

LESSEE ACCOUNTING -- IMPLEMENTAL ISSUES

IMPLEMENTAL ISSUE ONE:

> What criteria should be used to identify leases that are to be capitalized?

The existence of any one of the following criteria should be regarded as conclusive evidence of a lease transaction which is in substance an installment purchase which should be capitalized.

a. Lessee builds up a material equity in the leased property.

b. Lease term approximates the estimated useful life of the property (i.e., is equal to 75% or more of the estimated useful life of the property.)

c. Lessee guarantees directly lessor's debt with respect to the leased property, and such debt is substantial in relation to the cost of the property.

d. Lease passes usual risks and rewards of ownership to lessee.

e. Residual value of the property at the end of the lease is expected to be nominal.

f. Lease agreement provides that the lessor will recover his investment plus a fair return.

The existence of one or more of the following criteria should be considered to be suggestive (not conclusive) evidence that a lease transaction is in substance an installment purchase which should be capitalized.

a. Leased property is special purpose to the lessee.

b. Lessee directly pays costs normally incident to ownership.

c. Lessee treats the lease as a purchase for tax purposes.

d. Lease is between related parties.

e. Lessee assumes an unconditional liability for lease rentals. (However, the Division believes that this condition establishes conclusively that the lease arrangement results in debt to the extent of the unconditional liability which should be recognized in financial statements.)

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

In prescribing criteria to identify leases which should be capitalized, special consideration should be given to leases which cover less than substantially all of the physical unit of property.

IMPLEMENTAL ISSUE TWO:

What changes, if any, in circumstances occurring after the inception of a lease should cause a reconsideration of the decision as to how the lease should be accounted for?

Changes in lease terms by mutual agreement of the parties and changes in the relationship of the parties from one of independence to one of affiliation should cause a reconsideration of the decision as to how to account for the lease. In such circumstances only, the lease should be treated as a new transaction for purposes of determining the appropriate accounting.

IMPLEMENTAL ISSUE THREE:

> How should the amount to be capitalized be computed?

The amount to be capitalized should be computed at its present value using the interest rate implicit in the terms of the lease at the time of entering into the lease. If that rate is not ascertainable, interest rates applicable to the financing of purchases of similar types of properties by the lessees at the time of entering into the lease agreement should be used as indicators of an appropriate interest rate. In applying such interest rate to determine the present value of the lease obligation, the rental payment base should be "net" and renewal or purchase options and contingent payments should not be considered except when the exercise of the options appears clearly compelling from an economic viewpoint and the contingent payments, or any portion thereof, are not "contingent" in substance, but are relatively certain of payment.

The Division acknowledges the difficulties inherent in determining an appropriate interest rate when tax considerations are a major factor in the transaction and, although it takes no position at this time, encourages the Board to explicitly cover this problem in its exposure draft on accounting for leases.

IMPLEMENTAL ISSUE FOUR:

How should capitalized leases be presented in the balance sheet?

Assuming that the Board accepts the Division's position as to those leases which should be capitalized (Basic Issue One), the Board should not require that capitalized leases be presented as separate assets and obligations in the balance sheet. The Board should only require separate disclosure in the balance sheet or in the notes to financial statements of the amounts of capitalized assets and obligations under lease arrangements.

IMPLEMENTAL ISSUE FIVE:

What information concerning leases should be disclosed in footnotes to the financial statements of lessees?

Assuming that only leases which are in substance installment purchases are required to be capitalized, information disclosed in footnotes to the financial statements of lessees concerning non-capitalized leases should , in general, be that required under APB Opinion No. 31, Disclosure of Lease Commitments by Lessees. However, information required by the last sentence of Paragraph 9 of that Opinion (relating to classification by major categories of leased properties) and information on the present value of commitments suggested in Paragraph 11 of the Opinion should not be required. If the Board does not require obligations which arise in leases which are in substance installment purchases to be capitalized, information concerning the present value of such obligations should also be included in the footnotes.

IMPLEMENTAL ISSUE SIX:

> Which of the criteria previously discussed, or other criteria should be used to identify leases which include land that are to be capitalized?

Leases which include land should be capitalized if any of the following criteria are met:

a. The lessee builds up a material equity in the land as a result of a "bargain purchase" option.

b. The land lies under improvements which are leased under an arrangement which is in substance an installment purchase of the improvement.

c. The lease is of sufficient term that the present value of the lease rentals is substantially equivalent (e.g., 85% or more) to the value of the land.

A minority of the Accounting Standards Executive Committee believes that only leases involving land which meet the criteria in "a" above should be capitalized, since only those leases are, in the minority's view, in substance purchases.

IMPLEMENTAL ISSUE SEVEN:

> What accounting disposition should be made of leased land which has been capitalized?

Leased land which is capitalized should be amortized in a rational and systematic manner over the term of the lease. If however, the leased land were capitalized as a result of a "bargain purchase" option and it is clear such option will be exercised, the leased land should be accounted for as owned land and not amortized.

IMPLEMENTAL ISSUE EIGHT:

> Under what criteria, if any, should a sale-leaseback transaction be accounted for as two independent transactions?

Most sale-leaseback transactions should not be accounted for as two independent transactions. In particular, sale-leaseback transactions in which the lease would be capitalized pursuant to the criteria identified in our response to Basic Issue One and sale-leaseback transactions for the purpose of subsidizing or supporting rental operations of the buyer during a start-up period should not be viewed as two independent transactions. Short-term sale-leaseback transactions entered into to accommodate short-term property requirements of the seller may qualify as two independent transactions.

IMPLEMENTAL ISSUE NINE:

> How should those sale-leaseback transactions that may not be accounted for as independent transactions be accounted for?

Sale-leaseback transactions that may not be accounted for as independent transactions should be accounted for (a) as financing arrangements (i.e., loans) for a lease with terms which would require capitalization as an installment purchase under the criteria set forth in the response to Implemental Issue One, or (b) as a sale with deferral of profit. See the AICPA Industry Audit Guide, Profit Recognition on Sales of Real Estate, for a discussion of the accounting appropriate for certain real estate transactions.

IMPLEMENTAL ISSUE TEN:

> Should the accounting and reporting issues for lessees and lessors discussed in the various sections of the Discussion Memorandum apply to nuclear fuel leases in essentially the same manner as with other types of leases?

Yes.

LESSOR ACCOUNTING -- BASIC ISSUES

BASIC ISSUE TEN:

> Should leases which are the equivalent of sales be accounted for as such by the lessor?

Yes.

BASIC ISSUE ELEVEN:

> Should manufacturer or dealer lessors be permitted to recognize a proportionate share of their profit with respect to some leases which are not the equivalent of sales?

No.

BASIC ISSUE TWELVE:

> Under what circumstances, if any, should the sale by a manufacturer or dealer of an operating lease or of property subject to an operating lease to an independent third party be accounted for as a sale? When such a transaction does not qualify as a sale, should the lessor account for it as a borrowing?

A sale by a manufacturer or dealer of an operating lease should not be accounted for as a sale but (a) as a loan if the arrangement provides for recourse to the seller for uncollected rents, or (b) as a transaction resulting in advance rent (deferred income) if such recourse does not exist. A sale by a manufacturer or dealer of properties subject to an operating lease should be accounted for as a sale only if it is not accompanied by guarantees or other arrangements which are designed to insure the buyer of a return of his investment. If such guarantees or other arrangements exist, the transaction would generally be the equivalent of a loan. On the other hand, if no such guarantees or arrangements exist but other significant risks are retained by the manufacturer or dealer, sales should be deferred unless the risks can be clearly measured, in which case allowance should be made for those risks.

BASIC ISSUE THIRTEEN:

> If the transaction referred to in Basic Issue Twelve is with a related party, under what circumstances, if any, should it be accounted for as a sale or as a partial sale to the extent of the outside interest in the related party?

A sale by a manufacturer or dealer lessor to a related party of an operating lease should be accounted for as explained in our response to Basic Issue Twelve. A sale by such lessors of property subject to an operating lease would normally involve conditions indicating that the seller has retained either (a) risks of such substance that all profit on the sale should be deferred, or (b) obligations to the related party of such significance that the sale should be accounted for as a loan. Profits should not be recognized if the related party is directly or indirectly under the control of the seller or vice-versa.

However, transactions involving sales of real estate subject to operating leases to related parties in whom the seller has an interest may not involve the above-mentioned circumstances and recognition of profit to the extent of the outside interest in the related party may be appropriate if the seller has not retained risks which are disproportionate to his retained ownership.

In general, the Division believes that the provisions of APB Opinion No. 27 and of the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate, specify appropriate accounting for such transactions.

BASIC ISSUE FOURTEEN:

> Should the accounts of all subsidiaries or controlled companies whose principal business activity is leasing be consolidated?

If the principal business activity of a subsidiary or controlled company is leasing to the parent company or other affiliates, the accounts of such subsidiaries or controlled companies should be consolidated. If the principal business activity is leasing to others, the issue of consolidation should be dealt with under the provisions of ARB No. 51 until such time as the Board may issue a standard dealing comprehensively with principles of consolidation.

BASIC ISSUE FIFTEEN:

> Should leases which are considered to be financing arrangements for the purchase of property be identified by the same criteria as those which are considered equivalent to sales of property?

Yes; however, the retention of some risks by the lessor/seller may necessitate deferral of some or all of the profit on sales.

BASIC ISSUE SIXTEEN:

> Aside from the question of accounting for manufacturing and dealer profit, should leases which are considered financing leases and those which are considered the equivalent of sales be accounted for in the same way regardless of the type of lessor involved?

BASIC ISSUE SEVENTEEN:

> Should profit or loss, other than interest, on a leasing transaction which is considered equivalent to a sale be accounted for in the same manner by a lessor who is not nominally a dealer as by a lessor dealer?

Yes, provided it is practicable to distinguish profit or loss from the interest element on the leasing transaction. However, an intermediate party to a leasing transaction, such as a financing institution, should not treat such transactions as sales.

LESSOR ACCOUNTING -- IMPLEMENTAL ISSUES

IMPLEMENTAL ISSUE ELEVEN:

> What criteria should be used to identify leases that should be accounted for as equivalent to sales?

The same criteria which are used to identify leases which are in substance an installment purchase by a lessee should be used to identify leases that should be accounted for as equivalent to sales.

IMPLEMENTAL ISSUE TWELVE:

> In determining whether a lease is a "full payout" lease, how should the residual value of the leased asset be treated, and what consideration should be given to certain other factors?

The residual value of the leased asset should be taken into account in determining whether a lease is a "full payout" lease based on an estimated amount which does not exceed the lower of (a) 5% of the total of the present value of the receivable arising in the lease transaction plus the present value of the recognized residual value of the leased asset, or (b) the amount discounted, for which there is a high degree of certainty of realization through sale or subsequent lease. No profit should be recognized, however, by manufacturers or dealers with respect to, and to the extent of, residual value until the residual is sold.

For the purpose of determining whether a lease is a "full payout" lease, (a) normal selling price or fair value of the leased property should be regarded as the lessor's investment in the leased property (in the case of recently acquired property, the lessor's purchase cost can be regarded as equivalent to fair value), (b) investment tax credits retained by the lessor should be regarded as a reduction of the lessor's investment in the leased property, (c) purchase or renewal options given to the lessee should be disregarded unless their terms are such as to make it clear they will be exercised, and (d) rentals the amounts of which are based on some factor other than the passage of time should be disregarded unless collection is assured beyond any reasonable doubt.

IMPLEMENTAL ISSUE THIRTEEN:

> What criteria should be used to identify participations by independent third parties in property subject to operating leases that may properly be accounted for as sales by manufacturers or dealers?

In order for manufacturers or dealers to account for such "participations" as sales, the "sales price" should provide for a "full payout" and the arrangement should provide for no retention of ownership risks. In general, the Division believes that the provisions of APB Opinion No. 27 specify the appropriate accounting for "participations" by independent third parties in property subject to operating leases.

IMPLEMENTAL ISSUE FOURTEEN:

> What obligations of a manufacturer or dealer to indemnify the third party participant when a lease is terminated constitute a retention of risks sufficient to preclude accounting for the participation as a sale?

The existence of any of the following obligations of a manufacturer or dealer should preclude accounting for a "participation" as a sale.

a. An obligation to repurchase the lease or the property.

b. An obligation to substitute an existing lease.

c. An obligation to secure a replacement lessee or buyer which gives priority to the property owned by the third party.

d. An obligation to secure a replacement lessee or buyer on a first-in, first-out basis.

e. An obligation to secure a replacement lessee or buyer on a "best efforts" basis.

f. An obligation to accept the leased property under a "trade-in" option which tends to expose the manufacturer or dealer to significant risks or loss on disposition of the property traded in.

IMPLEMENTAL ISSUE FIFTEEN:

What criteria should be used to identify leases that should be accounted for by the lessor as financing arrangements for the purchase of property by the lessee?

The same criteria used to identify leases which are in substance installment purchases by the lessee should be used to identify leases that should be accounted for by the lessor as financing arrangements for the purchase of property by the lessee.

IMPLEMENTAL ISSUE SIXTEEN:

Considerations in computing the net asset representing gross rentals less unearned income for leases that are accounted for as sales and as financing arrangements.

The interest rate used to discount gross receivables to their present value should be determined following the general guides set forth in APB Opinion No. 21, paragraphs 13 and 14.

Gross rental payments should be reduced for amounts necessary to reimburse the lessor for services to be performed or other costs, including administrative costs, to be borne.

No recognition should be given to renewal and purchase options unless it is clear beyond any reasonable doubt that they will be exercised.

No recognition should be given to contingent rentals unless it is clear beyond any reasonable doubt that they will be received.

Residual value discounted to present value should be shown as a separate asset.

IMPLEMENTAL ISSUE SEVENTEEN:

> Is the information concerning leases presently required under APB Opinion No. 7 to be disclosed in financial statements of lessors adequate for the needs of users?

Yes, but information as to the amounts of rentals due under existing noncancellable operating and financial leases and the periods over which such amounts are due would increase the utility of financial statements of lessors.

IMPLEMENTAL ISSUE EIGHTEEN:

> Under what circumstances, if any, should leases involving land be considered as equivalent to sales and accounted for as such?

A lease involving land should be considered as equivalent to a sale by a lessor if the lease meets the criteria that would establish that the lease is in substance an installment purchase by the lessee, unless the lessor is an intermediate party, such as a financial institution, to the leasing transaction. See our response to Implemental Issue Six for such criteria and for a minority view which also applies to this issue.

Profit recognition on leases of land which are accounted for as sales under these criteria should be subject to the same considerations that would apply to profit recognition on sales of land pursuant to sale contracts. Accordingly, profit recognition on the installment basis would be appropriate for many such transactions because of the absence of any significant downpayment.

IMPLEMENTAL ISSUE NINETEEN:

> Under what circumstances, if any, should leases involving land be considered as financing leases and accounted for as such?

Leases involving land should be considered as financing leases by a lessor if the leases meet the criteria to identify land leases which should be capitalized by lessees. (See response to Implemental Issue Six.)

LEVERAGED LEASES -- BASIC ISSUES

BASIC ISSUE EIGHTEEN:

> Are leveraged leases unique in the sense that special accounting standards are required to recognize their economic nature?

Leveraged leases contain characteristics which differentiate them from other lease transactions and, therefore, accounting standards for such leases must give recognition to their special characteristics.

BASIC ISSUE NINTEEN:

> If leveraged leases are judged to be unique, how should they be defined so as to delineate clearly the area within which standards of accounting for leveraged leases will apply?

Leveraged leases should be defined as three-party financing leases in which a majority of the financing of the asset is in the form of nonrecourse debt and the rentals under the lease agreement are sufficient to service the nonrecourse debt.

BASIC ISSUE TWENTY:

> Under what concept should a leveraged lease be accounted for?

Income from leveraged leases should be accounted for under the three-party financing lease concept. The Division also believes that the lessor should (1) not account for its receivable as net of the nonrecourse loan, (2) account for residual value in the same manner as under other financing leases and account for related tax effects pursuant to APB Opinion No. 11, (3) account for earnings on reinvested funds as such earnings are received, (4) account for the investment tax credit as part of the yield on its receivable, and (5) account for tax benefits from current and cumulative tax timing differences pursuant to APB Opinion No. 11.

A minority of the Accounting Standards Executive Committee believes that a lessor should account for the receivable on its balance sheet net of the nonrecourse loan since this method of classification is more in accord with the substance of such three-party transactions.

LEVERAGED LEASES -- IMPLEMENTAL ISSUES

IMPLEMENTAL ISSUE TWENTY:

> What, if anything, should be excluded from the computation of projected net income from a leveraged lease to determine whether the lease has a negative payback, i.e., has an "inherent loss"?

Estimated earnings on reinvested funds should be excluded from the computation of projected net income in determining whether a leveraged lease has a negative payback.

IMPLEMENTAL ISSUE TWENTY-ONE:

> Should the projected loss from a negative payback lease be given immediate recognition?

No. It should be recognized over the term of the lease unless it is clear that estimated earnings on reinvested funds will not exceed the amount of the projected loss.

IMPLEMENTAL ISSUE TWENTY-TWO:

> Aside from the question of the disclosure of accounting methods followed, what information with respect to leveraged leases should be disclosed in lessor's financial statements to satisfy users' needs?

The information disclosed in the financial statements of lessors with respect to leveraged leases should be the same as that disclosed for other financing leases.

IMPLEMENTAL ISSUE TWENTY-THREE:

> Should any new accounting standard for leases be applied retroactively or prospectively?

Any new accounting standard should be applied prospectively to new leases. However, the Division believes that a type of pro-forma disclosure with respect to prior financing leases which would be capitalized under any new accounting standard would be appropriate.

A significant minority of the Accounting Standards Executive Committee disagrees with this conclusion and recommends that any new accounting standard should be applied retroactively.

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ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

October 11, 1974

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