

Financial reporting developments

A comprehensive guide

Lease accounting

Revised November 2014



Building a better
working world

To our clients and other friends


We are pleased to provide you with this updated edition of our Financial Reporting Developments publication, *Lease accounting*. This edition of our publication primarily has been updated from our prior edition to reflect updates to relevant accounting standards.

The classification of a lease for accounting purposes can have a significant impact on the financial position and earnings reported by either party to a lease transaction. The accounting guidance discussed in this publication affects entities engaged in leasing activities as either a lessee or lessor and requires both lessees and lessors to classify leases based on specified criteria. There is a high degree of complexity in accounting for lease transactions. The consequences of incorrectly assessing accounting requirements can be severe if the goal was to obtain off-balance sheet financing. Accordingly, it is important to carefully assess the propriety of a specific lease transaction prior to consummation.

For many companies, a lease transaction is an infrequent and significant event. This guide is designed to provide a summary, in one location, of the lease accounting rules. Companies that are involved in lease accounting transactions on a regular basis will be familiar with many of the issues described herein. However, those companies as well as companies that only occasionally consider lease transactions often need the advice and assistance of professional advisors to evaluate the facts and circumstances that may be encountered in a particular transaction.

The November 2014 updates to this publication provide additional considerations for evaluating non-performance covenants when classifying and measuring a lease. We also provide additional insight into how to determine the inputs to a sales-type lease. The updates also highlight new guidance issued by the FASB in ASU 2014-05, *Service Concession Arrangements*, which was primarily codified in ASC 853, *Service Concession Arrangements* (ASC 853). Arrangements within the scope of ASC 853 are not within the scope of ASC 840, *Leases*. See Appendix D for additional details about updates to this publication.

Ernst & Young professionals are prepared to help you identify and understand the issues related to lease accounting. In addition, our audit and tax professionals would be pleased to discuss with you any other issues relating to your proposed transaction.

The logo for Ernst & Young LLP, featuring the company name in a stylized, cursive script font.

November 2014

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Certain abbreviations of accounting standards are used throughout this publication. Those abbreviations are defined in Appendix A.

Notice to readers:

This publication includes excerpts from and references to the FASB Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the codification are shown using these reference numbers. References are also made to certain pre-codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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1 Scope

A lease is an agreement conveying the right to use property, plant or equipment. Under a lease the party obtaining the right to use the leased property is referred to as a lessee and the party conveying the right to use the property is referred to as a lessor. Accounting guidance for lease arrangements for both lessees and lessors under US GAAP is primarily contained in ASC 840 and is applicable to all entities.

1.1 Determining whether an arrangement contains a lease

Excerpt from Accounting Standards Codification

Lease

An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

Leases – Overall

Scope and Scope Exceptions

840-10-15-3

The evaluation of whether an arrangement contains a lease within the scope of the Leases Topic shall be based on the substance of the arrangement using the following guidance. That evaluation shall be made at inception of the arrangement based on all of the facts and circumstances. Paragraph 840-10-35-2 establishes the criteria under which a reassessment of whether an arrangement contains a lease after the inception of the arrangement shall be made.

840-10-15-4

This Topic does not address whether an undivided interest or a pro rata portion of property, plant, or equipment could be the subject of a lease. The issue of how to determine if a component part of property, plant, or equipment is itself property, plant, or equipment is not a subject of this Topic. Nevertheless, arrangements that identify a physically distinguishable portion of property, plant, or equipment are within the scope of this Topic.

ASC 840-10-15 provides a model for determining whether an arrangement contains a lease based on the following:

- ▶ The arrangement involves the use of property, plant or equipment (as described in Section 1.1.1),
- ▶ The property, plant or equipment in the arrangement is either explicitly or implicitly identified (as described in Section 1.1.2), and
- ▶ The arrangement conveys to the purchaser/lessee the “right to use” the specified property, plant or equipment (as described in Section 1.1.3).

The model is described in the following sections using excerpts from ASC 840.

An undivided interest in an asset represents an economic right to the output of an asset rather than an economic right to the asset itself. When developing the model for determining whether an arrangement contains a lease, the EITF was unable to reach a consensus on whether a pro rata portion of the output of an asset can be the subject of a lease and therefore, ASC 840 is silent on the issue. However, physically distinguishable portions of property, plant or equipment can be the subject of a lease and within the scope of ASC 840 (e.g., one or more floors of a multi-story office building).

1.1.1 Property, plant or equipment

ASC 840-10-15-15 provides guidance on what assets are intended to be subject to lease accounting, describing property, plant or equipment as land and/or depreciable assets:

Excerpt from Accounting Standards Codification

Leases – Overall

Scope and Scope Exceptions

840-10-15-15

Because a lease is defined as conveying the right to use property, plant, or equipment (land and/or depreciable assets), inventory (including equipment parts inventory) and minerals, precious metals, or other natural resources cannot be the subject of a lease for accounting purposes because those assets are not depreciable. This Topic does not apply to lease agreements concerning the rights to explore for or to exploit natural resources such as oil, gas, minerals, timber, precious metals, or other natural resources. Similarly, intangibles such as workforce and licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights are not deemed the subject of a lease for accounting purposes even though those assets may be amortized.

1.1.2 Specified assets

In order for a transaction to qualify as a lease, the arrangement must be dependent on specified property, plant or equipment. The property, plant or equipment can be either explicitly or implicitly identified and performance is dependent on the specified asset, as noted in the following excerpts:

Excerpt from Accounting Standards Codification

Leases – Overall

Scope and Scope Exceptions

840-10-15-5

The identification of property, plant, or equipment in the arrangement need not be explicit; it may be implicit. Property, plant, or equipment has been implicitly specified if, for example, the owner-seller owns or leases only one asset with which to fulfill its obligation to the purchaser and it is not economically feasible or practicable for the owner-seller to perform its obligation through the use of alternative property, plant, or equipment.

840-10-15-10

The definition of a lease 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. Further, although specific property, plant, or equipment may be explicitly identified in an arrangement, it is not the subject of a lease if fulfillment of the arrangement is not dependent on the use of the specified property, plant, or equipment.

840-10-15-11

For example, if the owner-seller is obligated to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other property, plant, or equipment not specified in the arrangement, then fulfillment of the arrangement is not dependent on the specified property, plant, or equipment and the arrangement does not contain a lease. Most arrangements that call for delivery of an asset that has quoted market prices available in an active market will generally not be dependent on specific property, plant, or equipment to fulfill the arrangement.

840-10-15-12

Other property, plant, or equipment not specified in the arrangement may include property, plant, or equipment owned or controlled by the owner-seller, or it may include a third party's property, plant, or equipment (for example, if the owner-seller purchases goods or services in the spot market to fulfill its obligation under the arrangement).

840-10-15-13

The owner-seller's right and ability to provide goods or services using other property, plant, or equipment does not always mean that the arrangement does not contain a lease. For example, a warranty obligation that permits or requires the substitution of the same or similar property, plant, or equipment if the specified property, plant, or equipment is not operating properly does not preclude lease treatment.

840-10-15-14

In addition, a contractual provision (contingent or otherwise) permitting or requiring the owner-seller to substitute other property, plant, or equipment for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

840-10-55-26

Paragraph 840-10-15-5 states that the identification of the property in the arrangement need not be explicit; it may be implicit. For example, in the case of a power purchase contract, if the seller of the power is a special-purpose entity that owns a single power plant, that power plant is implicitly specified in the contract because it is unlikely that the special-purpose entity could obtain replacement power to fulfill its obligations under the contract because a special-purpose entity generally has limited capital resources. Similarly, in a throughput contract, the seller may have only a single pipeline and the prospect of obtaining access to a second pipeline may not be economically feasible. In that circumstance, the seller's pipeline is implicitly specified in the contract. If, on the other hand, no property, plant, or equipment is explicitly specified in the contract and it is economically feasible for the seller to perform its obligation independent of the operation of a particular asset, there would be no implicit specification of the property, plant, or equipment and such a contract would not contain a lease.

Under ASC 840-10-15-5, if property, plant or equipment is not explicitly specified in the contract and it is economically feasible for the seller to perform its obligation independent of the operation of a particular asset, such a contract would not contain a lease. If it is not economically feasible for the seller to perform its obligation through the use of alternative property, plant or equipment, then the asset has been implicitly specified in an arrangement and could be the subject of a lease. The following two arrangements help illustrate this concept.

- ▶ In the case of a power purchase contract, if the seller of the power is a single-purpose entity (SPE) that owns a single power plant, that power plant is implicitly specified in the contract because it is unlikely that the SPE could obtain replacement power to fulfill its obligations under the contract because an SPE generally has limited capital resources.
- ▶ In the case of a throughput contract (see Section 1.3 for a description of a throughput contract), the seller may have only a single pipeline and the prospect of obtaining access to a second pipeline may not be economically feasible. In that case, the seller's pipeline is implicitly specified in the contract.

1.1.3 Right-to-use property, plant or equipment

ASC 840-10-15-6 provides guidance for determining whether an arrangement conveys to the purchaser (lessee) the right to use specific (as described in Section 1.1.2) property, plant or equipment (as described in Section 1.1.1).

Excerpt from Accounting Standards Codification

Leases – Overall

Scope and Scope Exceptions

840-10-15-6

An arrangement conveys the right to use property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment. The right to control the use of the underlying property, plant, or equipment is conveyed if any one of the following conditions is met:

- a. The purchaser has the ability or right to operate the property, plant, or equipment or direct others to operate the property, plant, or equipment in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment. The purchaser's ability to operate the property, plant, or equipment may be evidenced by (but is not limited to) the purchaser's ability to hire, fire, or replace the property's operator or the purchaser's ability to specify significant operating policies and procedures in the arrangement with the owner-seller having no ability to change such policies and procedures. A requirement to follow prudent operating practices (or other similar requirements) generally does not convey the right to control the underlying property, plant, or equipment. Similarly, a contractual requirement designed to enable the purchaser to monitor or ensure the seller's compliance with performance, safety, pollution control, or other general standards generally does not establish control over the underlying property, plant, or equipment.
- b. The purchaser has the ability or right to control physical access to the underlying property, plant, or equipment while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment.
- c. Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant, or equipment during the term of the arrangement, and the price that the purchaser (lessee) will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

840-10-15-7

Example 2 (see paragraph 840-10-55-32) illustrates further the assessment of the possibility that other parties will take more than a minor amount of the output.

840-10-15-9

This Topic also includes agreements that, although not nominally identified as leases, meet the definition of lease, such as a heat supply contract for nuclear fuel.

Pending Content:

Transition Date: (P) December 15, 2014; (N) December 15, 2014. | **Transition Guidance:** 853-10-65-1

Editor's note: The content in paragraph 840-10-15-9A will be added upon the adoption of ASU 2014-05, *Service Concession Arrangements (Topic 853)*. For public business entities, ASU 2014-05 is effective for annual periods beginning after December 15, 2014, and interim periods therein. For other entities, ASU 2014-05 is effective for annual reporting periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015. Early adoption is permitted.

840-10-15-9A

Service concession arrangements within the scope of Topic 853 on service concession arrangements are not within the scope of the guidance in this Topic.

Implementation Guidance and Illustrations

840-10-55-34

All evidence should be considered when making the assessment as to the possibility that other parties will take more than a minor amount of the output, including evidence provided by the arrangement's pricing. For example, if an arrangement's pricing provides for a fixed capacity charge designed to recover the supplier's capital investment in the subject property, plant, or equipment, the pricing may be persuasive evidence that it is remote that parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant, or equipment.

The guidance in ASC 840-10-15-3 (see Section 1.1) requires that the evaluation of whether an arrangement conveys the right to use the asset should be based on the substance of the arrangement. The fact that a contract is labeled a "transportation contract" or a "lease" is not necessarily determinative of whether the arrangement is a lease or not. Therefore, the parties to the arrangement must carefully analyze the terms of the contract to determine whether the arrangement transfers the right to use property, plant or equipment to the purchaser (lessee) based on the guidance in ASC 840-10-15-6. Executory contracts and agreements for services that involve the use of equipment but do not convey the right to use the equipment to the recipient of such services are not leases and should be accounted for as a service agreement.

The guidance in ASC 840-10-15 pertaining to determining whether an arrangement contains a lease was codified primarily from EITF 01-8. The EITF in its basis for consensus for EITF 01-8 (paragraph B14 of EITF 01-8) noted that clarifying "right to use" in the manner described in ASC 840-10-15-6 may result in many take-or-pay contracts being recognized as leases (see Section 1.2 for the definition of a take-or-pay contract). That is because the purchaser makes payments for the property, plant, or equipment to be made available for use (often referred to as a capacity charge) rather than on the basis of actual use or output. In many take-or-pay arrangements, the purchaser is contractually committed to pay the supplier irrespective of whether the purchaser actually uses the property, plant, or equipment or obtains the output from the property, plant, or equipment. In such arrangements, the purchaser is paying for the right to use the property, plant, or equipment.

Numerous questions have arisen regarding the "fixed per unit of output" and "market price per unit" discussion in ASC 840-10-15-6(c). These were intended to be extremely limited exceptions that were meant to be taken literally. The fixed price criteria means absolutely fixed, with no variance per unit based on underlying costs or volumes (either discounts or step pricing), no matter how minor. Market is intended to address those items for which there is a readily available, actively traded market (e.g., electricity). In addition, market price per unit means the cost is solely a market cost without other pricing factors (e.g., market price per kwh plus percent change in price of natural gas would not be market).

Service concession arrangements in the scope of ASC 853, *Service Concession Arrangements*, (ASC 853) are excluded from the scope of ASC 840. For service concession arrangements within the scope of ASC 853, the operating entity should refer to other US GAAP (e.g., revenue recognition guidance). See Section 1.12 for additional information on identifying a service concession arrangement and determining whether the arrangement is in the scope of ASC 853.

1.1.4 Reassessment of the arrangement

The following excerpts from ASC 840 provide guidance on when an arrangement should be assessed and reassessed to determine whether it contains a lease based on the guidance in ASC 840-10-15.

Excerpt from Accounting Standards Codification

Leases – Overall

Subsequent Measurement

840-10-35-2

A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if any of the following conditions exist:

- a. Change in contractual terms. The arrangement should be reassessed if the contractual arrangement among the parties involved changes, unless the change only renews or extends the arrangement.
- b. Renewal or extension. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement shall be evaluated only with respect to the renewal or extension period. The accounting for the remaining term of the original arrangement shall continue without modification. The exercise of a renewal option that was included in the lease term at the inception of the arrangement shall not be considered a renewal for the purpose of reevaluating the arrangement. Accordingly, the exercise of the renewal option shall not trigger a reassessment.
- c. Dependency upon specific property, plant, or equipment. A change in the determination as to whether or not fulfillment is dependent on specified property, plant, or equipment requires a reassessment of the arrangement to determine whether the arrangement contains a lease on a prospective basis.
- d. Physical change to specific property, plant, or equipment. A substantial physical change to the specified property, plant, or equipment requires a reassessment of the arrangement to determine whether the arrangement contains a lease on a prospective basis. For purposes of determining if a physical change to the specified property, plant, or equipment gives rise to a reassessment, increases or decreases in productive capacity that result from adding or subtracting a physically distinct unit of property, plant, or equipment shall be ignored if fulfillment of the arrangement is dependent upon a distinct unit of property, plant, or equipment that remains unchanged.

840-10-35-3

Changes in estimate (for example, the estimated amount of output to be delivered to the purchaser or other potential purchasers) shall not trigger a reassessment. A reassessment of an arrangement shall be based on the facts and circumstances as of the date of reassessment, including the remaining term of the arrangement. Examples 3 through 5 (see paragraphs 840-10-55-35 through 55-37) illustrate the reassessment of whether an arrangement contains a lease.

Implementation Guidance and Illustrations

Example 3: Reassessing Whether an Arrangement Contains a Lease—Exercise of a Renewal Option

840-10-55-35

This Example illustrates whether reassessment of the scope of this Subtopic is required by paragraph 840-10-35-2. A lease with a base term of 10 years and a purchaser renewal option for a second 10-year period would be classified as having a 20-year term if the lease imposed a penalty on the lessee in

such an amount that, at lease inception, the renewal option was determined to be reasonably assured of being exercised. In that circumstance, the exercise of the renewal option would not trigger a reassessment of whether the arrangement contains a lease.

Example 4: Reassessing Whether an Arrangement Contains a Lease—Dependency on Specific Property, Plant, or Equipment

840-10-55-36

This Example illustrates whether reassessment of the scope of this Subtopic is required by paragraph 840-10-35-2. If an arrangement was initially determined to include a lease because, in part, fulfillment of the arrangement was initially dependent upon specific property, plant, or equipment and an event or events occurred after the inception of the arrangement such that fulfillment was no longer dependent upon the specific property, plant, or equipment (for example, an active market for the product develops after inception of the arrangement), the arrangement would be reassessed to determine if the arrangement contains a lease as of the date that the arrangement is no longer dependent upon specific property, plant, or equipment.

Example 5: Reassessing Whether an Arrangement Contains a Lease—Physical Change to Property, Plant, or Equipment

840-10-55-37

This Example illustrates whether reassessment of the scope of this Subtopic is required by paragraph 840-10-35-2. A machine generates 100 units of productive capacity at inception. If the seller increases capacity to 200 units by installing a second machine that is physically distinct from (and capable of being operated independently of) the original machine, the increase in capacity would not give rise to a reassessment if the original machine is specified in the arrangement and fulfillment of the arrangement is dependent on the specified machine. However, if the seller is able to provide output from either machine, a reassessment under the guidance in 840-10-35-2 may be warranted. Conversely, if the original machine were replaced by a new machine that is capable of generating 200 units of productive capacity, reassessment would be appropriate.

Leases – Operating Leases

Recognition

840-20-25-9

If a supply arrangement (or a portion of a supply arrangement) becomes an operating lease due to a modification to the arrangement or other change (see paragraph 840-10-35-2), any recognized asset (such as a prepaid asset or a derivative instrument) for the purchase contract shall be considered by the lessee part of the minimum lease payments and shall be initially recognized as prepaid rent. Any recognized liability (such as a payable or a derivative instrument) for the purchase contract shall be considered by the lessee a reduction of the minimum lease payments and shall be initially recognized as a lease payable.

840-20-25-22

If a supply arrangement (or a portion of a supply arrangement) becomes an operating lease due to a modification to the arrangement or other change (see paragraph 840-10-35-2), any recognized liability (such as a deferred revenue or derivative instrument) for the sales contract shall be considered by the lessor part of the minimum lease payments and shall be initially recognized as deferred rent. Any recognized asset (such as a receivable or derivative) for the sales contract shall be considered by the lessor a reduction of the minimum lease payments and shall be initially recognized as a lease receivable provided the asset is recoverable from future receipts.

Derecognition**840-20-40-2**

If a supply arrangement (or a portion of a supply arrangement) ceases to be a lease due to a modification to the arrangement or other change (see paragraph 840-10-35-2), any recognized prepaid rent or rent payable shall be initially recognized by the lessee as an asset or liability associated with the purchase contract.

840-20-40-6

If a supply arrangement (or a portion of a supply arrangement) ceases to be a lease due to a modification to the arrangement or other change (see paragraph 840-10-35-2), any recognized deferred rent or rent receivable shall be initially recognized by the lessor as a liability or an asset associated with the sales contract, subject to a recoverability test.

Leases – Capital Leases***Recognition*****840-30-25-4**

If a supply arrangement (or a portion of a supply arrangement) becomes a sales-type lease due to a modification to the arrangement or other change, the following guidance shall be applied by the lessor to account for the revised categorization of the arrangement:

- a. If the criteria for sale treatment in paragraph 840-10-25-42 (or other applicable guidance, such as Subtopic 360-20) are met, the lessor shall do both of the following:
 1. Derecognize the property, plant, or equipment
 2. Recognize in earnings any recognized asset or liability for the supply arrangement as an adjustment of the minimum lease payments.
- b. If the criteria for sale treatment are not met, the lessor shall do both of the following:
 1. Consider any recognized asset or liability for the supply arrangement a reduction of (or part of) the minimum lease payments
 2. Follow the guidance in the Leases Topic with respect to recognition of the lease.

Initial Measurement**840-30-30-5**

If a supply arrangement (or a portion of a supply arrangement) becomes a capital lease due to a modification to the arrangement or other change, any recognized asset or liability (such as a prepaid asset, a payable, or a derivative instrument) for the purchase contract shall be included by the purchaser-lessee in the basis of the leased asset or lease obligation.

Derecognition**840-30-40-2**

If a supply arrangement (or a portion of a supply arrangement) ceases to be a lease due to a modification to the arrangement it shall be accounted for by the lessee as follows:

- a. If the leased asset is other than real estate (including integral equipment), the property, plant, or equipment and related lease obligation shall be derecognized.
- b. If the leased asset is real estate (including integral equipment), derecognition of the property, plant, or equipment and related capital lease obligation is subject to the guidance in Subtopic 360-20.

840-30-40-3

Before recognizing a sale, the asset subject to the capital lease shall be assessed by the lessee for impairment under the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10. That assessment should consider the terms of any revisions to the arrangement that caused the lessee to reassess whether the arrangement is a lease. Any difference between the capital lease asset and obligation (after reducing the asset for any impairment) is initially recognized as an asset or liability associated with the supply arrangement.

840-30-40-4

For an illustration of how a seller-lessee determines whether equipment subject to a sale-leaseback is integral equipment, see Example 5 (paragraph 360-20-55-57).

1.1.5**Multiple-element arrangements that contain a lease****Excerpt from Accounting Standards Codification****Leases – Overall****Scope and Scope Exceptions****840-10-15-8**

Agreements that transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of this Topic even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.

840-10-15-16

In determining whether an arrangement is within the scope of this Topic, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and shall, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting, including a lease. That presumption may be overcome if there is sufficient evidence to the contrary.

840-10-15-17

If an arrangement contains a lease and related executory costs, as well as other non-lease elements, the classification, recognition, measurement, and disclosure requirements of this Topic shall be applied by both the purchaser and the supplier to the lease element of the arrangement.

840-10-15-18

Other elements of the arrangement not within the scope of this Topic shall be accounted for in accordance with other applicable generally accepted accounting principles (GAAP).

840-10-15-19

For purposes of applying this Topic, payments and other consideration called for by the arrangement shall be separated at the inception of the arrangement or upon a reassessment of the arrangement into:

- a. Those for the lease, including the related executory costs and profits thereon.
- b. Those for other services on a relative fair value basis, consistent with the guidance in paragraph 605-25-15-3A(b).

As the separate recognition of a lease that is embedded in a multiple-element arrangement is required, both the purchaser and supplier must separate the portion of the total payments that are attributable to the lease and related executory costs (executory costs include taxes, maintenance and insurance) from

the payments that are attributable to the non-lease elements. These non-lease elements are considered “substantial services,” examples of which are raw material supply arrangements, supplies and labor and other costs of operating the asset. The arrangement consideration should be allocated between the lease deliverables (i.e., the lease and related executory costs) and the non-lease deliverables on a relative fair value basis in accordance with ASC 605-25-15-3A(b). Note that ASC 840-10-15-19 describes the basis upon which consideration should be allocated between lease elements and non-lease elements as a “relative fair value” basis, whereas ASC 605-25-15-3A(b) describes the basis as a “relative selling price” basis. These terms have equivalent meaning within this context. See our Multiple-element arrangements FRD for further discussion on allocating arrangement consideration in multiple-deliverable arrangements.

A key issue discussed by the EITF in developing the guidance for multiple-element arrangements containing a lease is whether all products and services provided by the lessor in a multiple-element arrangement are considered executory costs as that term is used with respect to accounting for leases under ASC 840 and, therefore, should be deducted from total consideration that the lessee is obligated to pay, or can be required to pay, in connection with the leased property in determining minimum lease payments. The EITF concluded that substantial services provided by the lessor (e.g., significant operating services) are not executory costs within the scope of ASC 840 (paragraph B6 of EITF 01-8). The payments and other consideration called for by the arrangement should be separated at the inception of the arrangement or on a reassessment of the arrangement (as described in ASC 840-10-35-2 – see Section 1.1.4). A key feature of ASC 605-25-15-3A(b) is that separating the lease elements from the non-lease elements in a multiple-element arrangement is not elective. That is, regardless of whether objective evidence of fair value exists, the lease elements still must be separated from the non-lease elements and accounted for under ASC 840. Once the lease elements have been separated from the non-lease elements, the executory costs that will be paid to the lessor, if any, must be estimated (including a reasonable profit thereon) and excluded from the minimum lease payments for purposes of assessing lease classification.

The following example illustrates the guidance presented above:

Illustration 1-1: Allocating payments to lease and non-lease elements

Company R enters into an arrangement with a customer to lease a photocopier for three years and supply a stated monthly quantity of paper and toner for the 3-year period. The arrangement fee is \$1,000 per month for both the photocopier lease and the paper and toner supply arrangement. Since other vendors can supply the fixed quantity of paper and toner, fair value for these substantial services easily can be determined (\$200 per month). In addition, the lessor typically leases this type of photocopier, without the other elements, over a 3-year period for a monthly rental of \$900 per month.

Using a relative fair value basis, Company R would determine the payments to allocate to the lease elements and the non-lease elements as follows:

Lease Elements:

$$900/(200+900) \times 1,000 = \$818$$

Non-Lease Elements:

$$200/(200+900) \times 1,000 = \$182$$

Accordingly, \$818 per month of the arrangement consideration would be allocated to the lease of the copier (and executory costs, if applicable), and \$182 to the non-lease element (i.e., the paper and toner supply arrangement). The non-lease element would be analyzed under ASC 605-25 to determine whether separation of the components of the paper and toner supply arrangement is required. Revenue for the lease of the photocopier should be recognized pursuant to ASC 840 and the paper and toner supply contract pursuant to the general revenue recognition criteria in ASC 605 or SAB Topic 13.

In the event that the arrangement has payment terms that require the purchaser (lessee) to pay a fixed charge and a variable charge based on actual production taken on a monthly basis, it will be necessary to determine the consideration that relates to the lease elements and the non-lease elements. It is not appropriate to assume that the fixed charge payment relates solely to the lease elements in the arrangement as a portion of the fixed charge could relate to substantial services, such as raw material costs and services. In addition, it is not appropriate to estimate the fair value of the lease elements and conclude that the remaining portion of the fixed charge relates to the non-lease elements. ASC 840-10-15-19 requires that the consideration be allocated on a relative fair value basis. Therefore, we expect that most companies in this situation will be required to project the total costs of the arrangement and use their estimate of the fair value of the lease and non-lease elements to allocate the consideration on a relative fair value basis. If the consideration allocated to the lease elements is less than the fixed charge, then the fixed charge includes amounts related to the non-lease elements, in addition to the fair value of the lease elements. If the consideration allocated to the lease elements is in excess of the fixed charge, then a portion of the variable charge pertains to the lease elements and should generally be accounted for as contingent rent. See Section 2.13 for a discussion of the accounting for contingent rent.

1.1.6 Transition provisions

The provisions for determining whether an arrangement contains a lease in ASC 840-10-15 were codified primarily from EITF 01-8 and should be applied to all arrangements agreed to or committed to, modified or acquired in business combinations after the beginning of an entity's reporting period beginning after 28 May 2003. Arrangements that are determined to be leases based on application of this guidance are not subject to the provisions of ASC 840-40-15-5 (see Section 10.1) if the construction project was *committed to* prior to 28 May 2003, provided that construction commenced before 31 December 2004 (paragraph 16 of EITF 01-8). Note that the guidance in ASC 840-40-15-5 was codified primarily from EITF 97-10. As described in the transition guidance provided in EITF 97-10, a construction project is considered committed to if all construction-related contracts have been executed including (1) debt and equity financing agreements, (2) construction agency agreements and (3) other related lease agreements, such that the owner-lessor and other entities providing financing have a binding commitment to the project and the lessee has agreed to its involvement (as developer, general contractor, or construction manager/agent or in other capacities) in the project during the construction period.

1.1.7 Examples – Determining whether an arrangement contains a lease

The following examples are provided to assist with the application of the guidance presented above. Illustration 1-2 includes additional analysis not provided in ASC 840-10-55 to help demonstrate the accounting for multiple-element arrangements that contain a lease.

Excerpt from Accounting Standards Codification

Leases – Overall

Implementation Guidance and Illustrations

Example 1: Determining Whether an Arrangement Contains a Lease—Gas Supply Contract

840-10-55-30

This Example illustrates the application of the scope guidance in paragraph 840-10-15-6 and others. A production entity (the purchaser) enters into an arrangement with a third party to supply a minimum quantity of a specialty gas needed in its production process for a specified period of time. The supplier designs and constructs a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for all of the following:

- a. The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.

- b. The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
- c. The supplier is responsible for repairs, maintenance, and capital expenditures.
- d. The supplier must stand ready to deliver a minimum quantity of gas each month.
- e. On a monthly basis, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which comprise approximately 90 percent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- f. In the event that the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

840-10-55-31

Based on an evaluation of the circumstances, the arrangement contains a lease within the scope of this Subtopic. Property, plant, or equipment (the facility) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the facility. While the supplier has the right to supply gas from other sources, its ability to do so is nonsubstantive. The purchaser has obtained the right to use the facility because, based on the facts presented – in particular, the fact that the facility is designed to meet only the purchaser's needs and the fact that the supplier has no plans to expand or modify the facility – it is remote that any parties other than the purchaser will take more than a minor amount of the facility's output and the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

Example 2: Determining Whether an Arrangement Contains a Lease–Component Supply Arrangement

840-10-55-32

This Example illustrates the application of the scope guidance in paragraph 840-10-15-6 and others. A manufacturing entity (the purchaser) enters into an arrangement with a third party to supply a specific component part of its manufactured product for a specified period of time. The supplier designs and constructs a plant adjacent to the purchaser's manufacturing facility to produce the component part. The designed capacity of the plant exceeds the purchaser's current needs, and the supplier maintains ownership and control over all significant aspects of operating the plant. The arrangement provides for all of the following:

- a. The supplier's plant is explicitly identified in the arrangement, but the supplier has the right to fulfill the arrangement by shipping the component parts from another plant owned by the supplier. However, to do so for any extended period of time would be uneconomical.
- b. The supplier is responsible for repairs, maintenance, and capital expenditures of the plant.
- c. The supplier must stand ready to deliver a minimum quantity. The purchaser is required to pay a fixed price per unit for the actual quantity taken. Even if the purchaser's needs are such that they do not need the stated minimum quantity, they still only pay for the actual quantity taken.
- d. The supplier has the right to sell the component parts to other customers and has a history of doing so (by selling in the replacement parts market) such that it is expected that parties other than the purchaser will take more than a minor amount of the component parts produced at the supplier's plant.

840-10-55-33

Based on an evaluation of the circumstances, the arrangement is not within the scope of this Subtopic. Property, plant, or equipment (the plant) is explicitly identified in the arrangement and fulfillment of the arrangement is dependent on the facility. While the supplier has the right to supply component parts from other sources, the supplier would not have the ability to do so because it would be uneconomical. However, the purchaser has not obtained the right to use the plant because both of the following conditions exist:

- a. The purchaser does not have the ability or right to operate or direct others to operate the plant or control physical access to the plant.
- b. The likelihood that parties other than the purchaser will take more than a minor amount of the component parts produced at the plant is more than remote, based on the facts presented.

The following illustration uses modified information from the first example above to further depict the accounting when a multiple-element arrangement contains a lease (this illustration is not included in ASC 840-10-55).

Illustration 1-2: Accounting for multiple-element arrangements containing a lease**Assume the following facts:**

- ▶ The fixed capacity charge that the purchaser (lessee) must pay is \$150,000 per month. The purchaser will pay the fixed capacity charge regardless of whether it takes any of the facility's production.
- ▶ The variable charge that the purchaser (lessee) must pay is primarily comprised of the actual energy costs, raw materials and labor related to the facility.
- ▶ The original term of the arrangement is 10 years and the agreement provides for two renewal periods of 10 years each.

Evaluation:

The purchaser (lessee) must determine the amount of the consideration in the arrangement that relates to the lease deliverables and the non-lease deliverables. As noted above, the requirement to separate the lease deliverables from the non-lease deliverables is not elective. Therefore, even if the information is not readily available, the purchaser (lessee) will be required to estimate the fair value of the consideration that relates to the lease and the non-lease deliverables and to allocate the consideration to those deliverables. In limited circumstances, the pricing information may be obtained directly from the seller (lessor). However, in most circumstances, companies will be required to obtain the information from industry sources or outside specialists.

Assume in this scenario that the seller (lessor) does not provide an allocation of the consideration that relates to the lease and non-lease elements of the arrangement. Therefore, the purchaser (lessee) must estimate the fair value of the consideration that relates to these amounts. Using information gathered through its negotiation of this transaction, as well as similar past transactions, the purchaser (lessee) estimates that the fair value of the lease of a similar facility, for a similar term is approximately \$125,000 per month. In addition, the purchaser (lessee) determines that the fair value of the non-lease elements included in the fixed charge is \$35,000.

Using a relative fair value basis, the purchaser (lessee) determines the consideration to allocate to the lease elements and the non-lease elements as follows:

- ▶ \$117,188 ($\$125,000/\$160,000 \times \$150,000$) of the fixed charge should be allocated to the lease elements and will be accounted for in accordance with ASC 840. The purchaser (lessee) will be required to estimate the executory costs (taxes, maintenance, and insurance), if any, that will be paid to the seller (lessor) and exclude those amounts from the minimum lease payments for purposes of assessing lease classification.
- ▶ \$32,812 ($\$35,000/\$160,000 \times \$150,000$) of the fixed charge, as well as any variable charges, pertain to the non-lease deliverables and should be accounted for in accordance with other generally accepted accounting principles.

1.2 Take-or-pay contracts

A take-or-pay contract, as defined in the ASC Master Glossary, is an agreement between a seller and a purchaser in which the purchaser pays certain amounts in exchange for products or services. The purchaser must make specified minimum payments regardless of whether it receives the contracted products or services (e.g., contractually obligated to pay for 100,000 units per month regardless of any shortfall in units ordered or delivered). The scope of ASC 840, as specified in ASC 840-10-15, results in many take-or-pay contracts being classified as leases.

1.3 Throughput contracts

A throughput contract, as defined in the ASC Master Glossary, is an agreement between a processor and the owner of a processing facility that provides for the processor to pay specified amounts periodically in return for the processing of a product. The processor is obligated to provide specified minimum quantities to be processed in each period and is required to make cash payments even if it does not provide the contracted quantities. Generally, this type of contract specifies the quantity of product to be processed (versus use of the facility) and, therefore, is not considered a lease. If a specific facility were specified in the agreement, the agreement should be analyzed to determine if it is, in substance, a lease. As discussed in Section 1.1.2, throughput arrangements are subject to evaluation under ASC 840-10-15 and, therefore, should be analyzed to determine whether the arrangement contains a lease.

1.4 Heat supply contracts

Excerpt from Accounting Standards Codification

Leases – Overall

Implementation Guidance and Illustrations

840-10-55-7

A nuclear fuel lease meets the definition of a lease because 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 is irrelevant to this central point.

Heat supply (also called “burn-up”) contracts usually provide for payments by the user-lessee based on 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.

Some have argued that nuclear fuel lease arrangements should be excluded from the definition of a lease because they are similar in nature to take-or-pay contracts to supply other types of fuel, such as coal or oil, which are excluded from the definition of a lease. However, nuclear fuel leases meet the definition of a lease under generally accepted accounting principles because a nuclear fuel installation constitutes a depreciable asset. The distinction is that a nuclear fuel lease conveys the right to use a depreciable asset, whereas take-or-pay contracts to supply coal or oil generally do not.

1.5 Management agreements

Similar to a service agreement, a management agreement typically involves a party that manages a facility or equipment on behalf of the owner. The manager typically receives compensation at a stated rate and, in some cases, also participates in the earnings from leasing or operating the facility or equipment. Management agreements historically have not been considered leases; however, these arrangements are subject to evaluation under ASC 840-10-15 and, therefore, should be analyzed to determine whether or not the arrangement contains a lease. The balance of this Section has been developed based on real estate management agreements. It is, however, applicable to management agreements of other property. Each agreement should be evaluated based on the specific facts and circumstances present.

1.5.1 Real property management agreements

Many agreements regarding the management of real property (most often, real estate) provide the manager with substantial decision making authority regarding the day-to-day operations of the property while the owner retains other rights. The arrangements between the owner and manager vary from short-term to long-term; however, the owner generally retains the right to cancel the long-term contract subject to a termination penalty, which, in some cases, can be significant.

As discussed in Section 1.1, ASC 840-10-15 provides guidance in determining whether an arrangement conveys the right to use property, plant or equipment that should be accounted for as a lease rather than a service, supply or other arrangement. The model for determining whether an arrangement contains a lease is based on the following:

- ▶ The arrangement involves the use of property, plant or equipment,
- ▶ The property, plant or equipment in the arrangement is either explicitly or implicitly identified, and
- ▶ The arrangement conveys to the purchaser/lessee the “right to use” the specified property, plant or equipment.

While it is impossible to conclude whether all management agreements are or are not leases, the remainder of this Section discusses relevant portions of ASC 840-10-15 as well as factors to be considered in evaluating whether or not the arrangement is a lease.

An agreement to manage real estate clearly involves explicitly (or implicitly) identified property, plant and equipment. As a result, the evaluation is then focused on the right to use. ASC 840-10-15-6 provides guidance for determining whether an arrangement conveys to the purchaser (lessee) the right to use specific property, plant or equipment, as follows:

Excerpt from Accounting Standards Codification

Leases – Overall

Scope and Scope Exceptions

840-10-15-6

An arrangement conveys the right to use property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment. The right to control the use of the underlying property, plant, or equipment is conveyed if any one of the following conditions is met:

1.5.1.1

Right to operate

ASC 840-10-15-6(a) provides guidance for determining whether the property manager has obtained the right to use specified assets as follows:

Excerpt from Accounting Standards Codification

Leases – Overall

Scope and Scope Exceptions

840-10-15-6(a)

The purchaser has the ability or right to operate the property, plant, or equipment or direct others to operate the property, plant, or equipment in a manner it determines while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment. The purchaser's ability to operate the property, plant, or equipment may be evidenced by (but is not limited to) the purchaser's ability to hire, fire, or replace the property's operator or the purchaser's ability to specify significant operating policies and procedures in the arrangement with the owner-seller having no ability to change such policies and procedures. A requirement to follow prudent operating practices (or other similar requirements) generally does not convey the right to control the underlying property, plant, or equipment. Similarly, a contractual requirement designed to enable the purchaser to monitor or ensure the seller's compliance with performance, safety, pollution control, or other general standards generally does not establish control over the underlying property, plant, or equipment.

If the contractual arrangement provides for cancellation by the owner without significant termination penalties, we believe this is indicative that the manager does not have the ability or right to operate the property as defined in ASC 840-10-15-6(a) (see Section 2.14 for a definition of penalty).

If the termination penalty is significant (i.e., a barrier to cancellation by the owner), we believe the manager generally has substantive rights under the arrangement. Conversely, if the termination penalty is not significant, we believe the owner often has retained the right to operate the property through its ability to terminate the management agreement 'at will.' That is, the manager's rights to operate under the arrangement would generally not be considered significant due to the owner's termination rights. Absent significant rights under the arrangements, it would be difficult to argue that the manager has the right to operate/use the property associated with a lease arrangement as discussed in ASC 840-10-15-6(a).

Although some may assert termination penalties should not be considered when industry practice indicates a new manager will fund those penalties, we believe the new manager adjusts its fees to recoup those costs (plus interest) in the new arrangement. Thus, the owner has effectively financed the payment of the termination penalties with the new manager rather than avoided payment of the penalty. As a result, a termination penalty is present, regardless of who funds the initial payment at the termination date.

In some management agreements, the owner retains substantive rights, such as approval of operating budgets, capital improvement budgets and key management positions (e.g., general manager and finance manager). The retention of substantive approval rights by the owner typically indicates the manager is acting more as an agent of the owner rather than acting as a principle for its own benefit under a lease arrangement. Thus, these types of provisions are indicators of a service agreement.

The evaluation of the right to operate the property is also based on the degree of specificity in the contractual arrangement. In many cases, both the owner and the manager desire to have specific requirements regarding the quality, nature and level of service in the property's operations. Although the manager oftentimes establishes the specific criteria, the manager and owner contractually commit to those criteria and are equally constrained by the agreement, often limiting the degree of discretion in the operations of the property held by the manager. For example, management contracts may require the manager to maintain a specific level of service (e.g., full, limited or no service hotel) and the type of facility (e.g., short vs. long-term hotels, designation of commercial and retail space). In addition, property management contracts may stipulate the types of services the manager will provide (e.g., leasing, lobby or security personnel, reservations, custodial/maintenance) while other types of services (e.g., retail or restaurant service) may be prohibited. To the extent the manager is contractually required to maintain specified levels of service, these provisions of the arrangement tend to be indicators of a service agreement.

Conversely, if the management agreement merely requires the manager to operate the property under 'prudent operating practices' or in compliance with local laws, safety regulations, pollution control or other general standards, the manager would typically be viewed as having significant discretion over the operations of the property, which is generally considered an indicator of a lease arrangement.

1.5.1.2

Control physical access

ASC 840-10-15-6(b) provides guidance for determining whether the property manager has control over the physical access to specified assets as follows:

Excerpt from Accounting Standards Codification

Leases – Overall

Scope and Scope Exceptions

840-10-15-6(b)

The purchaser has the ability or right to control physical access to the underlying property, plant, or equipment while obtaining or controlling more than a minor amount of the output or other utility of the property, plant, or equipment.

Property management contracts typically provide the owner substantial unrestricted access to both the common areas as well as operational areas. Although local laws may restrict the owner's ability to access specific areas (e.g., occupied office, retail or residential space, or occupied hotel rooms), those restrictions are equally applicable to the manager and are not deemed to be "control over physical access" by the manager in the context of ASC 840-10-15-6(b). Thus, the manager's inability to control physical access to the property is typically an indicator of a service agreement.

1.5.1.3 Facts and circumstances

ASC 840-10-15-6(c) provides guidance for determining whether the property manager has a substantial portion of the benefits and risks associated with specified assets as follows:

Excerpt from Accounting Standards Codification

Leases – Overall

Scope and Scope Exceptions

840-10-15-6(c)

Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than a minor amount of the output or other utility that will be produced or generated by the property, plant, or equipment during the term of the arrangement, and the price that the purchaser (lessee) will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

If the owner has a significant degree of variability in the economic risks and rewards (i.e., total cash flow and residual fair value) associated with ownership of the property and will receive more than a minor amount of the economic benefit of the operations of the property, this would generally be an indicator that the management agreement is a service agreement.

In situations where the manager has assumed a substantial portion of the variability in the economic results of the operations and has a significant amount of the risks and rewards of ownership during the term of the arrangement, this is an indicator of a lease agreement. Noteworthy, is that in performing this evaluation, the manager's analysis of the arrangement under ASC 810, *Consolidation*, will often be useful.

1.5.1.4 Related party arrangements

In scenarios where the property owner is a related party (as described in Section 7.1) to the manager, careful consideration of the facts and circumstances surrounding the arrangement is required. That is, because of the related party nature of the contractual arrangements, there is a rebuttable presumption that the manager may have additional rights in substance that should be included in the evaluation.

1.6 Software license arrangements

Although ASC 840-10-15-15 (see Section 1.1.1) excludes licensing agreements from the scope of ASC 840, ASC 350-40-25-16 indicates that the accounting for license arrangements for internal-use software by the licensee should be analogized to the accounting for leases when determining whether an asset is acquired as a result of a software arrangement (i.e., capital vs. operating lease). Licensors would apply the guidance of ASC 985-605, *Software – Revenue Recognition* (see Section 1.6.2). See Section 1.6.1 for further discussion of accounting for software licensing agreements by licensees.

1.6.1 Licensee accounting

Companies often license internal-use software from third parties. Though ASC 840-10-15-15 excludes licensing agreements from the scope of ASC 840, ASC 350-40-25-16 provides that companies should analogize to ASC 840 when determining whether an asset is acquired as a result of a software licensing arrangement (i.e., capital lease vs. operating lease).

Lessees should classify all leases at the inception date as either capital or operating. As discussed further in Section 3, a lease is a capital lease if it meets any one of the following criteria; otherwise, it is an operating lease:

- ▶ Ownership is transferred to the lessee by the end of the lease term.

- ▶ The lease contains a bargain purchase option.
- ▶ The lease term is at least 75% of the property's estimated remaining economic life.
- ▶ The present value of the minimum lease payments at the beginning of the lease term is 90% or more of the fair value of the leased property to the lessor at the inception date, less any related investment tax credit retained and expected to be realized by the lessor.

In the event a software licensing agreement is deemed to be a capital lease, the software license should be amortized over the shorter of the license term or the software's useful life (assuming no transfer of ownership or bargain purchase option). If the licensing agreement contains a bargain purchase option or transfer of ownership, the license should be amortized over its useful life.

1.6.2 Lease of property, plant or equipment and software

As discussed in Section 1.1.5, if a multiple-element arrangement contains a lease, then the classification, recognition, measurement and disclosure provisions of ASC 840 shall be applied to the lease element of the arrangement. Non-lease elements of the arrangement (e.g., elements that are subject to the scope of ASC 985-605 or other authoritative literature) are not within the scope of ASC 840 and should be accounted for in accordance with other applicable generally accepted accounting principles. That is, any lease in any arrangement must be separated and accounted for pursuant to ASC 840 (see Section 1.1.5).

Accordingly, if a lease includes (1) a lease of property, plant or equipment (e.g., computer hardware) and (2) software elements, the revenue from the arrangement should be allocated between the lease and software elements. The revenue allocated to the lease of the tangible property should be accounted for pursuant to ASC 840. The revenue allocated to the software elements, including postcontract customer support (PCS) should be accounted for separately in accordance with the guidance in ASC 985-605. However, if the software is incidental to the property, plant or equipment as a whole (e.g., software embedded in an automobile) or the software and hardware functions together to deliver the tangible leased product's essential functionality (e.g., a leased computer and an operating system), the entire arrangement should be accounted for in accordance with ASC 840 (see our Software revenue recognition FRD for further discussion on factors to consider when determining if the software is incidental to the hardware or if the software is essential to the leased asset's functionality).

Allocation of arrangement fee

ASC 605-25-15-3A(b) provides that the allocation of an arrangement's consideration when it involves a sale or license of software and a lease of hardware or other tangible property (i.e., the allocation between lease and non-lease elements) should be done on a relative fair value basis. Accordingly, if an arrangement includes software elements that are within the scope of ASC 985-605 and computer hardware or other tangible property that is subject to the scope of ASC 840, the consideration under the arrangement should be allocated between the lease elements (i.e., the elements subject to the scope of ASC 840) and the elements subject to the scope of ASC 985-605 (i.e., the software and software-related elements) on a relative fair value basis using the vendor's best estimate of fair values. Separating the lease elements from the elements subject to the scope of ASC 985-605 is not elective, even if vendor-specific objective evidence (VSOE) of fair value of the elements does not exist. If more than one element of the arrangement is subject to the scope of ASC 985-605, any amounts allocated to the software elements should be further evaluated pursuant to the provisions of ASC 985-605 to determine if the software elements can be separated into differing units of accounting (see our Software revenue recognition FRD for additional information). Consider the following illustration:

Illustration 1-3: Accounting for a multiple-element arrangement involving a lease and software

A vendor enters into a 3-year arrangement with a customer to provide a packaged solution that includes computer hardware, a software license and PCS for the software. The licensed software is more than incidental to the arrangement and the hardware and software do not function together to deliver the product's essential functionality. The arrangement does not include significant production, modification or customization of the licensed software. Monthly payments of \$5,000 (\$180,000 in total) are due under the terms of the agreement. The vendor historically has offered 3-year term leases of computer hardware and software without granting the customers concessions. Collectibility of the lease payments is reasonably assured and no important uncertainties exist regarding the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

The vendor does not sell the hardware and software separately, but based on sales by other vendors of comparable hardware on a standalone basis, it estimates that the fair value of the three-year lease of the hardware (without software) is \$80,000. Management's best estimate of the fair value of the software and PCS included in the arrangement, were it to be sold on a standalone basis, is \$120,000. The lease payments would be allocated as follows:

	Management's best estimate of fair value	Proportion of fair value	Allocation of lease payments
Hardware	\$ 80,000	40%	\$ 72,000
Software and PCS	120,000	60%	108,000
		[$\$80,000/\$200,000$] [$\$120,000/\$200,000$]	
Total	<u>\$ 200,000</u>		<u>\$ 180,000</u>

For purposes of this example, assume the lease of the hardware qualifies as a sales-type lease. Accordingly, the vendor/lessor would classify the lease of the computer hardware as a sales-type lease, recognizing the initial sale and cost of sales relating to the computer hardware on delivery and the related interest income over the lease term in accordance with ASC 840-30 for sales-type lease accounting.

The \$108,000 allocated to the software and PCS should be further evaluated pursuant to ASC 985-605 to determine if the software can be accounted for separately from the PCS and the timing of revenue recognition.

Extended payment terms in lease arrangements

ASC 985-605 provides that a license fee should be presumed not to be fixed or determinable if a significant portion of the fee is due after the expiration of the license or more than twelve months after delivery. Accordingly, if the lease payments extend beyond twelve months, the entire portion of the contractual payments allocated to software elements is presumed not to be fixed or determinable. The presumption that the payments are not fixed or determinable may be overcome if the vendor has an established standard business practice of using long-term or installment (including long-term leasing) contracts and a history of successfully collecting under the original payment terms without making concessions. If the software portion of the contractual payments is deemed not to be fixed or determinable, the revenue attributable to the software should be recognized as each lease payment becomes due. See our Software revenue recognition FRD for further details.

1.7 Applicability to state and local governmental units

The accounting for leases by governmental units is governed by NCGA 5 and GASB 13. NCGA 5 requires governmental units to follow the provisions of Statement 13, which was primarily codified at ASC 840. Users of this guide should see the appropriate governmental literature for further details.

1.8 Applicability to current value financial statements

Excerpt from Accounting Standards Codification

Leases – Overall

Other Presentation Matters

840-10-45-2

If financial statements are prepared on a current value basis and a lease involving property meets any of the four criteria in paragraph 840-10-25-1 and both of the criteria in paragraph 840-10-25-42, the lessor shall classify the lease as a sales-type or direct financing lease, whichever is appropriate.

840-10-45-3

Subsequently, the carrying amount of the recorded investment in the lease payments receivable shall be adjusted in accordance with the valuation techniques employed in preparing the financial statements on a current value basis.

1.9 Lease broker

The difficulty in accounting for lease broker transactions is often determining whether the broker transaction is in substance a lease. Certain leasing transactions utilize a lease broker to act as an intermediary between the lessor and the lessee. The lease broker fee arrangement can be a relatively simple one where a lump-sum cash payment is paid to the broker at closing (when all or substantially all of the services were rendered, and the broker has no future service commitments or obligations associated with the lease). Alternatively, in certain more complex leasing transactions, lease brokers often assume additional risks, offer additional services and may receive additional benefits and compensation in various other forms. Lease broker participation in the terms of the lease may be so extensive that the broker appears to be a lessor or a lessee and not merely an intermediary. As a result, in certain instances what is intended to be a lease broker transaction may instead be considered a lease. Alternatively, although a lease broker may in form be a lessor, in substance he may merely serve as an intermediary.

There is no specific authoritative guidance for lease broker accounting. The most comprehensive guidance is the June 1980 AICPA Issues Paper, *Accounting by Lease Brokers*. Although that issue paper was never finalized, it does provide useful guidance in evaluating whether a transaction is a lease broker transaction or some form of lease agreement requiring the application of lease accounting provisions (i.e., ASC 840). The Issues Paper utilized a “substance over form approach” to lease broker transactions and recommends the following attributes be considered in determining whether a transaction should be accounted for as a lease broker transaction. The presence of some of the following factors should be evaluated to determine if the rights and responsibilities of the lease broker indicate that in substance the broker is a lessee and sublessor:

- ▶ The lease broker has or participates in title to the leased assets.
- ▶ The lease broker is a lessor for a part of the lease term.
- ▶ The lease broker has an investment in the leased assets through use of its own funds or through its credit.

- ▶ The lease broker receives tax benefits related to the leased assets.
- ▶ The lease broker is a party to a related financing obligation as debtor and guarantor.
- ▶ The lease broker's obligation is with or without recourse.
- ▶ The lease broker has assumed obligations that involve primary or market risk, for example, guarantees of a specific amount of residual value.
- ▶ The lease broker has assumed a secondary credit risk by guaranteeing payments by the lessee under the initial lease.
- ▶ The lease broker has agreed to remarket the assets at the end of the initial lease term.
- ▶ The lease broker has reinsured the primary market or secondary credit risks he has assumed.

See Section 1.10 for accounting by a lease broker for an interest in a residual value.

1.10 Acquisition of lease residual values

The following issues related to accounting for the purchase of lease interests or residual values are discussed in ASC 360, *Property, Plant, and Equipment*.

Excerpt from Accounting Standards Codification

Leases – Overall

Derecognition

840-10-40-4

For guidance on the acquisition of the residual value in leased assets by a third party, see paragraph 360-10-25-2.

Property, Plant, and Equipment – Overall

Recognition

360-10-25-2

This Section provides guidance on how a third-party entity shall account for the following:

- a. The acquisition from a lessor of the unconditional right to own and possess, at the end of the lease term, an asset subject to a lease
- b. The acquisition of the right to receive all, or a portion, of the proceeds from the sale of a leased asset at the end of the lease term.

360-10-25-3

At the date the rights in the preceding paragraph are acquired, both transactions involve a right to receive, at the end of the lease term, all, or a portion, of any future benefit to be derived from the leased asset and shall be accounted for as the acquisition of an asset. Both transactions are referred to as the acquisition of an interest in the residual value of a leased asset.

360-10-25-4

An interest in the residual value of a leased asset shall be recorded as an asset at the date the right is acquired.

Initial Measurement***360-10-30-3***

An interest in the residual value of a leased asset recognized under paragraph 360-10-25-4 shall be measured initially at the amount of cash disbursed, the fair value of other consideration given, and the present value of liabilities assumed.

360-10-30-4

The fair value of the interest in the residual value of the leased asset at the date of the agreement shall be used to measure its cost if that fair value is more clearly evident than the fair value of assets surrendered, services rendered, or liabilities assumed.

Subsequent Measurement***360-10-35-13***

The following paragraph provides guidance on how an entity acquiring an interest in the residual value of a leased asset shall account for that asset during the lease term.

360-10-35-14

An entity acquiring an interest in the residual value of any leased asset, irrespective of the classification of the related lease by the lessor, shall not recognize increases to the asset's estimated value over the remaining term of the related lease, and the asset shall be reported at no more than its acquisition cost until sale or disposition. If it is subsequently determined that the fair value of the residual value of a leased asset has declined below the carrying amount of the acquired interest and that decline is other than temporary, the asset shall be written down to fair value, and the amount of the write-down shall be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset shall not be increased for any subsequent increase in its fair value before its sale or disposition.

The acquisition of the unconditional right to own and possess, at the end of the lease term, an asset subject to a lease or the right to receive all, or a portion, of the proceeds from the sale of a leased asset at the end of the lease are both transactions involving a right to receive all, or a portion, of any future benefit to be derived from the leased asset and should be accounted for as the acquisition of an asset. For the remainder of this section, both transactions are referred to herein as the acquisition of an interest in the residual value of a leased asset.

An interest in the residual value of a leased asset should be recorded as an asset at the amount of cash disbursed, the fair value of other consideration given and the present value of liabilities assumed at the date the right is acquired. The fair value of the interest in the residual value of the leased asset at the date of the agreement should be used to measure its cost if that fair value is more clearly evident than the fair value of assets surrendered, services rendered or liabilities assumed.

An enterprise acquiring an interest in the residual value of any leased asset, irrespective of the classification of the related lease by the lessor, should not recognize increases to the asset's estimated value over the remaining term of the related lease, and the asset should be reported at no more than its acquisition cost until sale or disposition. If it is subsequently determined that the fair value of the residual value of a leased asset has declined below the carrying amount of the acquired interest and that decline is other than temporary, the asset should be written down to fair value, and the amount of the write-down should be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset should not be increased for any subsequent increase in its fair value prior to its sale or disposition.

An interest in the residual value of a leased asset acquired by a lease broker for cash, liabilities assumed, and the fair value of other consideration given, including services rendered, should be accounted for under the foregoing provisions.

1.11 Lease accounting for a group of assets

Lease accounting principles are applied on an asset-by-asset basis. As a result, in applying the guidance in this manual to transactions involving numerous pieces of equipment or properties, it is often necessary to segregate the related lease agreements on an asset-by-asset basis (including sale-leaseback agreements). In general, the only assets that should be grouped are those assets that by their nature are functionally interdependent (e.g., a computer monitor and keyboard).

1.12 Service concession arrangements

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: (P) December 15, 2014; (N) December 15, 2014 | Transition Guidance: 853-10-65-1

Editor's note: The content in ASC 853 will be added upon the adoption of ASU 2014-05, Service Concession Arrangements (Topic 853). For public business entities, ASU 2014-05 is effective for annual periods beginning after December 15, 2014, and interim periods therein. For other entities, ASU 2014-05 is effective for annual reporting periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015. Early adoption is permitted.

Service Concession Arrangements – Overall

Overview and Background

General

853-10-05-1

A service concession arrangement is an arrangement between a grantor and an operating entity for which the terms provide that the operating entity will operate the grantor's infrastructure (for example, airports, roads, bridges, tunnels, prisons, and hospitals) for a specified period of time. The operating entity may also maintain the infrastructure. The infrastructure already may exist or may be constructed by the operating entity during the period of the service concession arrangement. If the infrastructure already exists, the operating entity may be required to provide significant upgrades as part of the arrangement. Service concession arrangements can take many different forms.

853-10-05-2

In a typical service concession arrangement, an operating entity operates and maintains for a period of time the infrastructure of the grantor that will be used to provide a public service. In exchange, the operating entity may receive payments from the grantor to perform those services. Those payments may be paid as the services are performed or over an extended period of time. Additionally, the operating entity may be given a right to charge the public (the third-party users) to use the infrastructure. The arrangement also may contain an unconditional guarantee from the grantor under which the grantor provides a guaranteed minimum payment if the fees collected from the third-party users do not reach a specified minimum threshold. This Topic provides guidance for reporting entities when they enter into a service concession arrangement with a public sector grantor who controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price (which could be set within a specified range). The grantor also controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

A service concession arrangement is an arrangement between a grantor and an operating entity that operates the grantor's infrastructure. Such arrangements may take various forms. A service concession arrangement within the scope of ASC 853 involves a public-sector entity grantor and an operating entity and meets two additional criteria described in ASC 853-10-15-3 as discussed below. A public-sector entity grantor may be a governmental body (e.g., a municipal government, a state government) or another entity to which a governmental body has delegated responsibility for providing a public service (e.g., a regional airport authority, a municipal transportation authority). Under such arrangements, the operating entity generally operates and maintains the public-sector entity's infrastructure (e.g., a highway, bridge, parking facility, power plant, hospital) that fulfills a public service for a period of time, in exchange for consideration (e.g., payments from the grantor, the right to charge third-party users of the assets). The operating entity may also construct the public-sector entity's infrastructure or upgrade the existing infrastructure.

We believe service concession arrangements within the scope of ASC 853 may be more prevalent outside the US, particularly in the energy and construction sectors (e.g., entities involved with assets such as power plants or bridges). However, all entities should evaluate each arrangement with a public-sector entity to determine whether the arrangement is in the scope of this guidance. Additionally, entities with equity method investees should also consider the accounting effects of their investees' service concession arrangements, if any.

Excerpt from Accounting Standards Codification

Pending Content:

Transition Date: (P) December 15, 2014; (N) December 15, 2014. | Transition Guidance: 853-10-65-1

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Service Concession Arrangements – Overall

Scope and Scope Exceptions

General

853-10-15-2

The guidance in this Topic applies to the accounting by operating entities of a service concession arrangement under which a public-sector entity grantor enters into a contract with an operating entity to operate the grantor's infrastructure. The operating entity also may provide the construction, upgrading, or maintenance services of the grantor's infrastructure.

853-10-15-3

A public-sector entity includes a governmental body or an entity to which the responsibility to provide public service has been delegated. In a service concession arrangement, both of the following conditions exist:

- a. The grantor controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price.
- b. The grantor controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

Recognition

General

853-10-25-1

An operating entity shall refer to other Topics to account for various aspects of a service concession arrangement. For example, an operating entity shall account for revenue and costs relating to construction, upgrade, or operation services in accordance with Topic 605 on revenue recognition.

853-10-25-2

The infrastructure that is the subject of a service concession arrangement within the scope of this Topic shall not be recognized as property, plant, and equipment of the operating entity. Service concession arrangements within the scope of this Topic are not within the scope of Topic 840 on leases, as indicated in paragraph 840-10-15-9A.

The guidance in ASC 853 applies only to the operating entity in a service concession arrangement that involves a public-sector entity grantor (grantor) and meets the following two conditions:

- ▶ The grantor controls or has the ability to modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them and at what price.
- ▶ The grantor controls, through ownership, beneficial entitlement or otherwise, any residual interest in the infrastructure at the end of the term of the arrangement.

Services

ASC 853 does not provide a framework for evaluating whether the grantor controls or has the ability to modify or approve the services that must be provided, to whom they must be provided and at what price. To be in the scope of ASC 853, we believe the grantor should have the substantive ability to control, modify or approve:

- ▶ The services that the operator must provide,
- ▶ To whom those services must be provided, and
- ▶ At what price those services must be provided.

All three conditions must be met. Therefore, the terms and conditions of each arrangement, including the rights of the operating entity and grantor, should be evaluated carefully. For example, even though the operating entity may have certain managerial or day-to-day decision making abilities in providing the required services (e.g., constructing, operating and maintaining a toll road), the grantor may retain the unilateral ability to control, modify or approve the services that the operating entity must provide with the infrastructure, to whom it must provide them, and at what price.

Importantly, a grantor need only have the ability to control, modify *or (emphasis added)* approve each of the conditions above. For example, a grantor may not control each condition in a contract where such conditions are agreed to up front (i.e., agreed to by both parties to the contract). However, the grantor may have to approve any changes, indicating the approval criteria would be met. Refer to Appendix C, Service concession arrangements (ASC 853) – decision tree for operating entities, for additional information.

When assessing whether the grantor controls or has the ability to set, modify or approve the price of the service provided, the arrangement need not establish a specific price. As described in ASC 853-10-05-2, the price in a service concession arrangement “could be set within a specified range.” Such arrangements should be evaluated to determine if the grantor set or approved the initially established price range and if it can also modify or must approve any subsequent price changes outside that range.

Control of the residual interest

The contractual terms of the arrangement will generally specify whether the grantor or the operating entity controls through ownership (or other means) any residual interest in the infrastructure at the end of the term of the arrangement.

Accounting for a service concession arrangement

For service concession arrangements that are in the scope of ASC 853, the operating entity should not account for the arrangement as a lease (i.e., in accordance with ASC 840) and should not recognize the infrastructure as property, plant and equipment (i.e., in accordance with ASC 360). Instead, the operating entity should refer to other US GAAP (e.g., ASC 605, *Revenue Recognition*) to account for the various aspects of a service concession arrangement. The FASB did not specify which aspects of US GAAP should be applied to service concession arrangements within the scope of ASC 853, except to say that service concession arrangements in the scope of both ASC 853 and ASC 980, *Regulated Operations*, (ASC 980) should be accounted for using ASC 980 instead of ASC 853. See Section 1.12.1 for additional information about service concession arrangements that may also be within the scope of ASC 980.

We believe operating entities will generally follow the revenue recognition guidance when accounting for service concession arrangements within the scope of ASC 853. This accounting may be similar to other non-lease service and management contracts where a party manages property or equipment on behalf of the owner. Arrangements not in the scope of ASC 853 should first be evaluated by the operating entity using the criteria in ASC 840 to determine whether lease accounting is appropriate.

The following example is provided to assist with the application of the service concession arrangements scope guidance in ASC 853-10-15-1 through 15-3:

Illustration 1-4: Accounting for a service concession arrangement

Assume the following facts:

- ▶ Company Q (Company Q or operating entity) enters into an arrangement with the State X Department of Transportation (referred to as the DOT), State X's governmental entity responsible for its public highways.
- ▶ Under the terms of the arrangement, Company Q will be required to perform the following services: construct, operate and maintain DOT's toll highway for a period of 20 years. The arrangement does not contain any renewal periods.
- ▶ The DOT will control any residual interest in the highway at the end of the 20 year contractual period.
- ▶ The arrangement requires Company Q to operate the toll highway by allowing the public to access and travel upon the constructed highway (i.e., a public service) in exchange for a toll that will be collected from each vehicle. The arrangement does not provide Company Q with any rights to unilaterally change the services that it must provide with the highway (e.g., roadway maintenance, emergency access and services, rest area concessions) or to whom it must provide the services.
- ▶ The arrangement initially sets the toll within a specified range, determined by the DOT, of \$0.50 to \$1.00 per vehicle. Future changes to the toll amount (i.e., price changes outside the specified range) require the DOT's approval.

Evaluation:

The arrangement is a service concession arrangement. The arrangement involves an operating entity (Company Q) and a public-sector entity grantor (the DOT) and the following two conditions are met:

- ▶ The DOT controls or has the ability to modify or approve the services that the operating entity must provide with the toll highway, to whom it must provide them, and at what price.
- ▶ The DOT controls, through ownership, beneficial entitlement, or otherwise, any residual interest in the toll highway at the end of the term of the arrangement.

Because the arrangement meets both criteria above it is in the scope ASC 853. Therefore, Company Q should not account for the service concession arrangement as a lease in accordance with ASC 840. Additionally, Company Q should not recognize the highway as its property, plant and equipment in accordance with ASC 360. Instead, Company Q should refer to other US GAAP to account for the aspects of the arrangement (e.g., revenue recognition guidance to account for tolls collected).

1.12.1**Service concession arrangements in regulated operations****Excerpt from Accounting Standards Codification****Pending Content:**

Transition Date: (P) December 15, 2014; (N) December 15, 2014 | **Transition Guidance:** 853-10-65-1

***Editor's note:** The content in ASC 853 will be added upon the adoption of ASU 2014-05, Service Concession Arrangements (Topic 853). For public business entities, ASU 2014-05 is effective for annual periods beginning after December 15, 2014, and interim periods therein. For other entities, ASU 2014-05 is effective for annual reporting periods beginning after December 15, 2014, and interim periods beginning after December 15, 2015. Early adoption is permitted.*

Service Concession Arrangements – Overall**Scope and Scope Exceptions****General****853-10-15-4**

A service concession arrangement that meets the scope criteria in Topic 980 on regulated operations shall apply the guidance in that Topic and not follow the guidance in this Topic.

A common characteristic between regulated operations and service concession arrangements is that the grantor (i.e., the regulator in the case of regulated operations) determines the price that can be charged for the service. However, in regulated operations the operating entity often controls the residual interest in the infrastructure (i.e., the infrastructure is often owned by the operating entity). Therefore, such arrangements in regulated operations generally would not be in the scope of ASC 853. In circumstances when the arrangement would otherwise be in the scope of both ASC 853 and 980 (e.g., an arrangement with an operating entity where the grantor is a state-owned utility that retains control over any residual interest in the infrastructure), the FASB specified that the service concession arrangement should be accounted for using the guidance in ASC 980 (i.e., the guidance in ASC 853 should not be applied to such arrangements). See ASC 980 for additional information about determining whether an arrangement is in the scope of that standard and for guidance about the recognition and measurement of such arrangements.

1.12.2 Service concession arrangements – transition provisions

For public business entities, the guidance in ASC 853 is effective for interim and annual periods beginning after 15 December 2014 (i.e., the first quarter of 2015 for calendar-year companies). For entities other than public business entities, the guidance is effective for annual periods beginning after 15 December 2014 (i.e., 2015 for calendar-year companies) and for interim periods within annual periods beginning after 15 December 2015 (i.e., the first quarter of 2016 for calendar-year companies). Early adoption is permitted.

Entities should apply the guidance on a modified retrospective basis to service concession arrangements in existence at the beginning of the fiscal year of adoption. The cumulative effects of adoption should be recognized as an adjustment to the opening balance of retained earnings in the year of adoption. Entities should also disclose the adoption of ASC 853 as a change in accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections* (ASC 250-10-50-1 through 50-3).

2 Definitions

2.1 Definitions used in this publication

This Section includes definitions of and guidance related to terms that are used throughout this publication. The terms included herein are broadly applicable (e.g., defined terms are used for both lessee and lessor accounting and defined terms are applicable to both capital and operating leases). We have also included guidance in this Section related to these defined terms to the extent that the guidance is broadly applicable.

2.2 Lease inception

Excerpt from Accounting Standards Codification

Lease Inception

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.

2.2.1 Lease inception date for equipment subject to a master lease agreement

Excerpt from Accounting Standards Codification

Leases – Overall

Implementation Guidance and Illustrations

840-10-55-2

This implementation guidance addresses applying the definition of lease inception when there is a master lease agreement.

840-10-55-3

If a master lease agreement specifies that the lessee must take a minimum number of units or dollar value of equipment and if all other principal provisions are stated, lease inception is the date of the master lease agreement with respect to the specified minimum.

840-10-55-4

Lease inception for equipment takedowns in excess of the specified minimum is the date that the lessee orders the equipment because the lessee does not agree to lease the equipment until that date.

840-10-55-5

To the extent that lease payments for required takedowns are based on value at the date of the takedown, the lease, in effect, has a preacquisition period escalator provision based on value.

840-10-55-6

If a master lease agreement does not require the lessee to takedown any minimum quantity or dollar value of equipment, the agreement is merely an offer by the lessor to rent equipment at an agreed price and lease inception is the date that the lessee orders the equipment.

A master lease agreement is a lease wherein a lessee can add equipment as needed under an existing lease agreement. In certain cases, a master lease agreement specifies minimum and maximum equipment dollars or quantities that can be required to be leased.

To the extent that a lessee is required under the terms of a master lease agreement to take a specified minimum quantity or dollar amount, the lease inception, with respect to the lease for that specified minimum, is the date of the master lease agreement (assuming that all other principal provisions of the lease are stated). To the extent that additional equipment beyond the specified minimum is leased under the master lease agreement, the lease inception with respect to the additional equipment is the date that the lessee orders the additional equipment. When lease payments under a master lease agreement with required minimum takedowns are based on value of the equipment at the date of the takedown, the lease, in effect, has a pre-acquisition period escalator provision based on the value of the equipment (see Section 2.3.5). If a master lease agreement does not require the lessee to lease a specified minimum quantity or dollar amount of equipment, the lease inception for the lease of any equipment takedowns under the master lease agreement is the date the lessee orders the equipment.

2.3

Fair value

Excerpt from Accounting Standards Codification

Fair Value of Leased Property

The price for which the property could be sold in an arm's-length transaction between unrelated parties.

Leases – Overall

Implementation Guidance and Illustrations

840-10-55-42

This guidance addresses the definition of fair value of the leased property.

840-10-55-43

If the lessor is a manufacturer or dealer, the fair value of the property at lease inception ordinarily will be its normal selling price, reflecting any volume or trade discounts that may apply. 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.

840-10-55-44

If the lessor is not a manufacturer or dealer, the fair value of the property at lease inception ordinarily will be its cost, reflecting any volume or trade discounts that may apply. However, if there has been a significant lapse of time between the acquisition of the property by the lessor and lease inception, the determination of fair value should be made in light of market conditions prevailing at lease inception, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different. (See paragraph 840-10-25-43(a)(2)(ii).)

Fair value of leased property is defined as the price for which the property could be sold in an arm's length transaction between unrelated parties. ASC 820, *Fair Value Measurement*, provides a framework for measuring fair value, defines fair value within that framework, and establishes fair value measurement disclosures. Importantly, the general definition of fair value in ASC 820 does not apply to fair value measurements for the purposes of lease classification and measurement under ASC 840. That is, the fair value of leased property, which is used in classifying a lease and to determine the maximum amount at which a lessee can record an asset leased under a capital lease is not a fair value measurement under the

framework set out in ASC 820. Although the definition of fair value of leased property used in ASC 840 may be viewed as similar to the definition of fair value in ASC 820, the framework for measuring fair value of leased property under ASC 840 is not consistent with the framework for measuring fair value under ASC 820.

The definition of fair value and the framework for measuring fair value set out in ASC 820 were codified primarily from Statement 157, which was issued by the FASB in September 2006. The FASB initially included all fair value measurements related to leases in the scope of Statement 157. However, after the issuance of Statement 157, concerns were raised that the use of Statement 157 to determine fair value for purposes of lease classification or measurement could result in unintended consequences (e.g., changing the classification of leases that were historically accounted for as direct finance leases to either sales-type or operating leases). As such, the FASB issued FSP FAS 157-1 in February 2008 to amend Statement 157 to exclude accounting pronouncements that address fair value measurements for the purpose of determining lease classification or measurement from the scope of Statement 157 (and therefore ASC 820). The FSP was effective upon the initial adoption of Statement 157.

Although fair value measurements for the purposes of lease classification and measurement under ASC 840 are excluded from the scope of ASC 820, other fair value measurements related to lease arrangements need to be determined in accordance with the guidance in ASC 820. Fair value measurements related to lease arrangements that are in the scope of ASC 820 include the following:

- ▶ Fair value measurements associated with lease assets acquired and liabilities assumed and intangible assets or liabilities recognized (e.g., related to favorable or unfavorable lease arrangements and in-place leases) in a business combination (see Section 13 and our Business combinations FRD).
- ▶ The measurement of impairment for assets under capital lease in accordance with ASC 360-10-35 (see Section 4.1.3 and our Impairment or disposal of long-lived assets FRD).
- ▶ The measurement of termination costs related to operating leases under ASC 420, *Exit or Disposal Cost Obligations* (see Section 4.3.10 and our Exit or disposal cost obligations FRD).
- ▶ The measurement of guarantees accounted for under ASC 460, *Guarantees* (see Sections 4.3.6, 5.5.1 and our Fair value measurements and disclosures FRD).
- ▶ The measurement of asset retirement obligations imposed by a lease agreement that meet the definition of an asset retirement obligation (ARO) and do not meet the definition of minimum lease payments or contingent rentals that are accounted for by the lessee in accordance with the requirements of ASC 410-20, *Asset Retirement Obligations* (see Section 2.9.1.6 and our Asset retirement obligations FRD).

Further information on applying the provisions of ASC 820 in these areas can be found in our Fair value measurements and disclosures, Business combinations, Asset retirement obligations, Impairment or disposal of long-lived assets and Exit or disposal cost obligations FRDs.

See Section 2.3.1 for further discussion of determining fair value for purposes of determining lease classification and measurement in accordance with ASC 840.

2.3.1 Determining fair value

Fair value is the selling price in an arm's-length transaction between unrelated parties. If a quoted market price is not available (e.g., for preexisting assets or leases of a portion of a building), then management must make an estimate of the fair value of the assets based on the best information available in the circumstances. In making such an estimate, companies should consider prices for comparable assets (e.g., sales of real estate) and the results of valuation techniques to the extent available in the circumstances.

The valuation techniques used should be consistent with the objective of measuring fair value (i.e., it should attempt to determine the amount at which the asset could be bought or sold in a transaction between a willing buyer and seller) and should incorporate assumptions that market participants would use in their estimates of the asset's fair value. In many cases, companies will rely on sales of similar assets, appraisals or estimates of discounted cash flows to estimate fair value. The determination of fair value should not be affected by the favorability or unfavorability of the lease being evaluated (including the leaseback of an asset accounted for under ASC 840-40). That is, fair value should not be increased or decreased based on the cash flows associated with the rental agreement, but instead should be based on market factors.

The appraisal process utilizes prices and values of comparable assets to determine an estimated price at which the asset could be sold. This often is achieved through a formal appraisal made by an outside specialist who has appropriate professional credentials to make such an estimate. An appraiser will estimate the sales value of the assets based on their highest and best use in a transaction between a willing buyer and a willing seller. This approach commonly is used for real property.

In many circumstances, an appraiser will use a discounted cash flow methodology for purposes of estimating fair value. Management also might decide to employ this methodology without the use of an appraiser. To estimate fair value based on discounted cash flows, two key pieces of information are needed: an estimate of the amount and timing of undiscounted cash flows and an appropriate discount rate that is commensurate with the risk involved. Some companies have established hurdle rates for making investment decisions (i.e., a minimum rate of return required on a new investment). This rate often will be helpful to management as it considers an appropriate discount rate to use when calculating discounted cash flows for estimating fair value.

In February 2000, the FASB issued CON 7, which provides general principles governing the use of present value techniques when the amount of future cash flows, the timing or both are uncertain. The FASB concluded that an expected cash flow approach to determining present value should be used and that estimated cash flows should reflect the probability-weighted range of possible cash flows rather than a single amount that is considered most likely. The statement concludes that the objective of a present value measurement is to determine fair value and that the measurement of an entity's liabilities should include the effects of the entity's credit standing. As a result, although CON 7 does not impact any of the literature affecting leases, the use of an expected cash flow approach to determining fair value would be an acceptable alternative.

2.3.2 Fair value used to perform 90% test

For purposes of performing the test (90% test) described in ASC 840-10-25-1(d) (see Section 3.2), fair value is the fair value of the leased property to the lessor at lease inception (see Section 2.2). See Section 3.2 for further details on performing the test described in ASC 840-10-25-1(d).

2.3.3 Manufacturer or dealer lessor's fair value

A manufacturer or dealer lessor's fair value of leased property ordinarily will be the normal selling price after any applicable volume or trade discounts. However, in some cases, fair value may be less than the normal historical selling price or less than cost because of market conditions. In addition, the fact that a company manufactures or deals in leased property does not preclude operating lease classification. For example, operating lease classification would result when a company manufactures and leases data processing equipment under short-term agreements that do not meet any of the criteria for a capital lease (lessee)/sales-type or direct finance lease (lessor). Further, as discussed in Section 2.3.6, in certain circumstances fair value for purposes of ASC 840-10-25-1(d) (see Section 3.2) would also include asset retirement obligations (AROs) associated with the leased asset.

2.3.4 Fair value when lessor is not a manufacturer or dealer

When the lessor is not a manufacturer or dealer, fair value ordinarily will equal cost after any applicable volume or trade discounts. In addition, as discussed in Section 2.3.6, in certain circumstances fair value for purposes of ASC 840-10-25-1(d) (see Section 3.2) would also include asset retirement obligations (AROs) associated with the leased asset. The fair value may be greater or less than cost or carrying amount, if different, because of the lapse of time between acquisition of the property and the inception of the lease.

Illustration 2-1: Fair value of leased property at lease inception

If a lessor purchases a shipping container in June for \$2,000 but the lease inception date is not until September at which time similar shipping containers are selling for \$1,800, the lessor would record a loss on a sales-type lease of \$200, based on the fair value.

2.3.5 Changes in fair value due to changes in construction or acquisition costs

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 should be considered in the determination of the "fair value of the leased property at lease inception" for purposes of evaluating whether the present value of minimum lease payments equal or exceed 90% of the fair value of the leased asset. For such leases, the effect of any increases in fair value should also be considered when determining the fair value of the leased property for purposes of initially measuring the asset and obligation recognized by the lessee for a capital lease (ASC 840-30-30-3 – see Section 4.1).

2.3.6 Effect of removal costs on the determination of fair value

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-15

Paragraph 410-20-15-3(e) addresses the scope application of Subtopic 410-20 to obligations of a lessee in connection with leased property.

840-10-25-16

Lease classification tests performed in accordance with the requirements of this Subtopic shall incorporate the requirements of Subtopic 410-20 to the extent applicable.

840-10-25-17

For example, if the recorded cost of an asset leased by a lessor is affected by the requirements of Subtopic 410-20, the application of the minimum-lease-payments criterion in paragraph 840-10-25-1(d) may be affected.

The provisions for accounting for AROs in ASC 410-20 were codified primarily from Statement 143. In the basis for conclusions of Statement 143, the FASB indicated that it was not their intent to amend the accounting literature for leases (paragraph B66 of Statement 143). However, AROs accounted for under ASC 410-20 have the potential to affect the classification of leases as capital or operating leases. We discussed this aspect of accounting for AROs with the FASB staff and obtained the following clarification.

The FASB intended that the fair value of the leased asset for purposes of evaluating the lease classification would include the ARO associated with the leased asset (although the FASB staff believes that an ARO would not be included in the fair value of a leased asset if the ARO existed only as a result of a requirement imposed on the lessor or lessee by the lease). That is, the fair value of the leased asset should include not only the net price at which the asset could be sold in an arm's-length transaction between unrelated parties but also the fair value of any ARO associated with the asset. Accordingly, the fair value of the leased asset generally would increase as a result of the application of ASC 410-20, and the percentage of the minimum lease payments compared to the fair value of the leased asset would be reduced, which would increase the likelihood of a lease being classified as an operating lease. See Section 2.9.1.6 for additional discussion of asset retirement obligations and their effect on the determination of minimum lease payments.

2.4 Bargain purchase option

Excerpt from Accounting Standards Codification

Bargain Purchase Option

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

The longer the period from inception of the lease (see Section 2.2) to the exercise date of an option, the more difficult it will be to determine whether the exercise of the option is reasonably assured. The difficulty arises from several factors. The further into the future a lessee is required to consider, the less precise will be the estimates of future needs for the leased asset. Also, the fair value of certain types of assets is more likely to change over time than will the value of other types of assets (e.g., the future value of a technology asset, such as a computer, is more difficult to predict than the future value of a relatively stable asset, such as a fully-leased commercial office building located in a prime area).

Accordingly, the further into the future the option date, the lower the option price must be in relation to the estimated future fair value to reasonably assure exercise. Also, the relationship at a future point in time between the option price and the estimated future fair value should be lower for an asset subject to significant changes in value than would be the case for an asset having a relatively stable value.

2.4.1 Methods of estimating fair value at the end of the lease term

Determining the fair value of the leased asset at the end of the lease term (see Section 2.6) for purposes of assessing whether an option is a bargain purchase option is often difficult because quoted future market prices are often not available. See Section 2.3.1 for additional information on determining fair value and Section 2.4.1.1 for considerations specific to determining fair value at the end of the lease term.

2.4.1.1 Impact of inflation on estimated fair value of leased property

For purposes of determining the fair value of the leased property at the end of the lease, inflation generally is not considered. In this regard, the estimated fair value of leased property at the end of the lease is based on price levels and market conditions existing at the inception of the lease. Possible future changes in specific market values or changes in the general purchasing power are not considered – to do otherwise would introduce appreciation into the historical cost model.

2.4.2 Economic penalty creates a bargain purchase option

Payment terms create penalty

In some lease agreements, a lessee is provided with an option at the end of a lease term (see Section 2.6) to either purchase the leased property or renew the lease. In some cases, if the lessee elects to renew the lease, the renewal lease payments are at amounts that exceed estimated fair value. In some cases, the economic disincentive for continuing to lease the property is so significant that it is reasonably assured that the lessee will exercise the purchase option. In those instances, the economic disincentive (penalty – see Sections 2.6.1 and 2.14) serves to convert an ordinary purchase option into a bargain (or a deemed guarantee of residual value – see Section 2.9.2) and results in the capitalization of the underlying leased asset. In other cases, the economic disincentive may not be so significant that it is reasonably assured that the lessee will exercise the purchase option and the option would not be considered a bargain purchase option.

External factors create penalty

In addition, there are instances where an economic penalty may exist that creates a bargain purchase option as a result of the significance of the leased asset(s) to the lessee's operations. For example, if a company leases a specialized facility (e.g., manufacturing plant, distribution facility or corporate headquarters) and an alternative facility is not readily available, the potential impact on operating income while a replacement asset is located, if possible, may represent a significant financial disincentive that turns an ordinary purchase option into a bargain purchase option. In the event that the purchase option relates to a group of assets, exercisable on an all or nothing basis, the extent of any economic penalty is assessed based upon the failure to purchase all assets subject to the lease. For example, if a company leases multiple retail locations from a single lessor, an option that requires the lessee to purchase or return all of the locations at the end of the lease would represent a significant financial disincentive to the extent that the loss of numerous locations would have a significant effect on the lessee's operations.

Lease term creates penalty

The lease term also should be considered to determine if it is artificially short (e.g., a lease of a corporate headquarters, distribution facility, manufacturing location or other key property with a 4-year lease term), effectively creating a compulsion for the lessee to exercise what would otherwise be considered a non-bargain purchase option. The compulsion to exercise the purchase option is evidenced by the significance of the facility to the issuer's continuing operations and, whether, absent the purchase option, the lessee would have entered into such a short-term lease. In leases with a fixed price purchase option and first dollar loss residual value guarantee (commonly referred to as a synthetic lease), we have often found that such a compulsion generally exists with lease terms of less than five years. However, a lease term of five or more years does not obviate the need to assess the reasonableness of the lease term relative to the significance of the leased asset to the lessee's continuing operations. In evaluating the lease term, only renewals that are at the sole discretion of the lessee can be considered.

2.4.3 Favorable purchase option contingent on external factors

For a purchase option to be considered a bargain purchase option, the exercise of the option, at lease inception (see Section 2.2), must be reasonably assured. Therefore, a favorable purchase option would not be considered a bargain purchase option if a contingency exists at the inception of the lease that would make the exercise of the option not reasonably assured.

Illustration 2-2: Determining whether a bargain purchase option exists

Assume a company leases equipment from a lessor under a 5-year lease that includes an option for the lessee to purchase the equipment at the end of the lease term for \$900,000. The lessee estimates that the equipment will have a fair value at the end of the lease term of \$1,000,000. The equipment is expected to be readily available in the market at the end of the lease term.

The lessee determined that the purchase option would not be considered reasonably assured of exercise and therefore a bargain because while it is priced below estimated fair value, the discount is not so significant that exercise rises to the level of reasonably assured. Therefore, the option does not qualify as a bargain purchase option.

2.5**Bargain renewal option****Excerpt from Accounting Standards Codification****Bargain Renewal Option**

A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at lease inception, to be reasonably assured. Fair rental of a property in this context shall mean the expected rental for equivalent property under similar terms and conditions.

If a lease contains a bargain renewal option, that option could affect the classification of a lease as a capital or operating lease because it directly affects the lease term (see Section 2.6). The longer the period from inception of the lease (see Section 2.2) to the exercise date of an option, the more difficult it will be to determine that exercise of the option is reasonably assured. The difficulty arises from several factors. The further into the future a lessee is required to consider, the less precise the estimates of future needs for the leased asset will be. Also, the fair value of certain types of assets is more likely to change over time than will the value of other types of assets (i.e., the future value of a high technology asset, e.g., a computer, is more difficult to predict than the future value of a relatively stable asset, e.g., a fully-leased commercial office building in a prime area) and the future fair value of the asset directly impacts the fair value of the underlying rent.

Accordingly, the further into the future the option date, the lower the option price must be (or the greater the penalty for failure to renew – see Sections 2.6.1 and 2.14 for further details) in relation to the estimated future fair value to reasonably assure exercise. Also, the relationship at a future point in time between the option price and the estimated future fair value should be lower for an asset subject to significant changes in value than would be the case for an asset having a relatively stable value.

2.6**Lease term****Excerpt from Accounting Standards Codification****Lease Term**

The fixed noncancelable lease term plus all of the following, except as noted in the following paragraph:

- a. All periods, if any, covered by bargain renewal options.
- b. All periods, if any, for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be reasonably assured

- c. All periods, if any, covered by ordinary renewal options during which any of the following conditions exist:
 - 1. A guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect.
 - 2. A loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding.
- d. All periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable
- e. All periods, if any, representing renewals or extensions of the lease at the lessor's option.

The lease term shall not be assumed to extend beyond the date a bargain purchase option becomes exercisable.

Noncancelable Lease Term

That portion of the lease term that is cancelable only under any of the following conditions:

- a. Upon the occurrence of some remote contingency
- b. With the permission of the lessor
- c. If the lessee enters into a new lease with the same lessor
- d. If the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured.

Indirectly Related to the Leased Property

The 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.

The lease term is the sum of all the following time periods, as applicable, but not beyond the date a bargain purchase option (see Section 2.4) becomes exercisable:

1. The fixed noncancelable term – that period during which a lease is cancelable only (a) on the occurrence of some remote contingency, (b) with the lessor's permission, (c) if a new lease is entered into between the same parties, or (d) on imposition of a penalty in such amount that continuation of the lease appears, at inception (see Section 2.2), reasonably assured.
2. Periods covered by bargain renewal options (see Section 2.5) – that is, an option that provides reasonable assurance at the inception date (see Section 2.2) that it will be exercised because the rental is sufficiently lower than the expected rental for equivalent property under similar terms and conditions at the exercise date.
3. Renewal periods when a penalty for failure to renew is so large that it appears there is reasonable assurance at the inception date (see Section 2.2) that the lease will be renewed.
4. Ordinary renewal option periods during which a lessee's guarantee of the lessor's debt directly or indirectly related to the leased property 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. The phrase indirectly related to the leased property is used 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.

5. Ordinary renewal option periods preceding the date a bargain purchase option becomes exercisable.
6. Periods for which the lessor has the option to renew or extend the lease.

2.6.1 Renewal penalty

When a penalty for failure to renew a lease at the end of a lease term (prior to renewal term) is so significant that it is reasonably assured at the inception date (see Section 2.2) that the lease will be renewed, the renewal period is included in the lease term for purposes of determining a lease's classification as a capital or operating lease.

The cancellation penalty must be sufficiently large to represent a significant deterrent to cancellation, which is a matter that can only be decided by judgment in the particular circumstances. Generally, a penalty would not reasonably assure renewal of the lease unless it is for an amount that is significant in relation to the lease payments that otherwise would have to be paid after the cancellation date. Other factors also should be considered, such as the expected availability of other assets to serve the lessee's needs, the practicality of surrendering the leased property and the attractiveness of the ongoing rental price.

When a penalty is large enough to conclude that renewal is reasonably assured, the amount of the renewal payments and not the amount of the penalty is included in the minimum lease payments (see Section 2.9). When a penalty is not large enough to conclude renewal is reasonably assured, the amount of the penalty is included in minimum lease payments to the extent that the penalty represents an actual cash payment (or other consideration) to the lessor or a third party (see Section 2.9).

2.6.2 Sublessee impact on lease term

In situations where, at inception of the lease (see Section 2.2), a lessee (head lease) has granted (or intends to grant) a sublessee an initial lease term or renewal rights extending beyond the initial term of the lessee's head lease arrangement, the head lessee is generally compelled to renew for a term covering all options available to the sublessee. That is, the lessee is presumed to have ceded its flexibility over exercise of its options to extend the head lease by virtue of granting the sublessee the right or options to use the property for that period of time.

The sublease term may not necessarily be consistent with the head lease term. This inconsistency is explained by the fact that although the sublease may convey a renewal option to a sublessee and, therefore, compels the head lessee to renew the head lease, it does not compel the sublessee to renew the sublease. The evaluation of the sublease term is an independent assessment.

Illustration 2-3: Evaluating a lessee's head lease term when a sublease exists

Company A leases land (the head lease) for an initial 5-year term followed by four successive 5-year renewal options. Company A immediately constructs a radio tower on the land and enters into a lease (as sublessor) with Radio Station B for an initial term of 5 years followed by three successive 5-year renewals at Radio Station B's option. In this case, the lease term used by Company A in its accounting for the head lease would be at least 20 years (i.e., the maximum period the sublessee can require Company A to renew the head lease). The sublease with Radio Station B would be independently evaluated and the lease term may be less than the 20-year period (e.g., may only be five years).

2.6.3 Guarantee of residual value at a point in time prior to expiration

Certain lease agreements enable a lessee to terminate the lease early, however, such early termination results in the lessee guaranteeing the residual value of the leased asset at the date of early termination. If, however, the lease runs through to its full term, the lessee does not guarantee the leased asset's residual value. In such lease agreements, an assessment of the guaranteed residual value is required to determine if it provides a significant incentive for the lessee to continue the lease for the full term. In certain cases, the guarantee of a residual value at a point in time prior to the end of the lease term may be considered a termination penalty for purposes of determining lease term and minimum lease payments.

Illustration 2-4: Guaranteeing of residual value upon early termination

A lessee guarantees to a lessor that if the lessee terminates the lease at the end of three years (of a 5-year lease term), the residual value at the end of three years will not be less than \$3,000. The \$3,000 potential payment at the end of three years will be included in the assessment of the lease term as a potential penalty on early termination.

As noted in Section 2.9.2.1, lessee guarantees of residual value under an operating lease are subject to the guidance in ASC 460, *Guarantees*. See Section 4.3.6 for a review of the accounting for residual value guarantees under ASC 460.

2.6.4 Fiscal funding clause

Excerpt from Accounting Standards Codification

Fiscal Funding Clause

A provision by which the lease is cancelable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement.

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840-10-25-3

The lease-term criterion in paragraph 840-10-25-1(c) addresses the lease term. The existence of a fiscal funding clause in a lease agreement requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If the likelihood of exercise of the fiscal funding clause is assessed as being remote, a lease agreement containing such a clause shall be considered a noncancelable lease; otherwise, the lease shall be considered cancelable and thus classified as an operating lease.

A fiscal funding clause is commonly found in a lease agreement in which the lessee is a governmental unit. A fiscal funding clause generally provides that the lease is cancelable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the lease agreement.

The existence of a fiscal funding clause in a lease agreement would necessitate an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If the likelihood of exercise of the fiscal funding clause is assessed as being remote (i.e., the chance of occurring is slight), a lease agreement containing such a clause would be considered a noncancelable lease. If the chance of exercise is assessed as being more than remote, the lease would be considered cancelable and classified as an operating lease.

2.6.5 Lessee's guarantee of lessor's debt or lessee loans to lessor

The lease term includes all periods, if any, covered by ordinary renewal options during which either (1) a guarantee by the lessee of the lessor's debt directly or indirectly related to the leased property is expected to be in effect or (2) a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding. The phrase "indirectly related to the leased property" is used 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.

In addition, to the extent that the lessor's debt is recourse only to the leased asset (either because the debt is non-recourse or the lessor has no significant assets other than the property under lease), a guarantee by the lessee of the lessor's non-recourse debt or a non-recourse loan made by the lessee to the lessor is tantamount to guaranteeing the residual value and accordingly, such guarantee should be included in the minimum lease payments for the purposes of the 90% test (see Section 2.9.2.6).

2.6.6 Lessor's option to renew lease

If the lessor can require the lessee to renew the lease then all periods covered by the renewal are included by the lessee in determining the lease term regardless of the relationship of the renewal to estimated fair value.

2.6.7 Lease term under a master lease agreement

A master lease agreement is a lease wherein a lessee can add equipment as needed under an existing lease agreement. In certain instances, a master lease specifies minimum and maximum equipment dollars or quantities that can be or are required to be added under the lease. The lease term for equipment under a master lease agreement generally is determined on an individual draw down (equipment under lease) basis. That is, as equipment is added to the master lease, an equipment schedule is typically prepared noting the assets to be leased, the term and the rate. For purposes of determining lease classification, equipment subject to a master lease generally should be evaluated on an equipment-by-equipment basis.

2.7 Economic life

Excerpt from Accounting Standards Codification

Estimated Economic Life

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 lease inception, without limitation by the lease term.

"Economically usable" means that the asset is, or is expected to be profitable to operate (exclusive of depreciation), and that no overall incremental saving could be effected by replacing it with another asset.

"By one or more users" means that the estimated economic life of the asset is to be viewed from the perspective of the existing lessee plus any successor lessees or owners.

“With normal repairs and maintenance” should be considered in conjunction with “economically usable.” Most assets reach a point when the cost of repairs and maintenance necessary to keep them operating becomes uneconomical. Repairs and maintenance beyond that point would not be “normal.” When evaluating normality, repairs and maintenance can differ depending on both the asset and the industry. In the airline industry, for example, extensive overhauls are regularly scheduled and should be considered “normal” in this context.

“For the purpose for which it was intended at the inception of the lease” presents the most difficulty in interpretation. For example, the DC-10 was introduced to U.S. trunk airlines over 40 years ago and many are still in commercial use, but only in more remote areas of the world. Likewise, hundreds of railroad cars have been converted into diners; lofts over abandoned warehouses in certain parts of Manhattan are in demand as apartments and artists’ studios. The intent of the requirement describes that period of time, estimated at the inception of the lease, during which the leased asset will be utilized in the capacity for which it was initially designed. Accordingly, an attempt should not be made to forecast unusual circumstances that would extend the useful life of an asset beyond reasonable expectations or would project unique uses. The DC-10 is a borderline case but, as for the railroad cars and warehouses, their secondary uses described above clearly are unrelated to what was “intended at the inception of the lease.”

In the DC-10 case, an aircraft may start out carrying passengers on scheduled flights of “trunk” lines, move next to passenger service on “feeder” lines, spend some time in charter service, carry freight and finally become the personal aircraft of a wealthy person. While it is not clear which of these purposes was “intended at the inception of the lease,” the expression should be given a relatively broad interpretation. Therefore, “purpose” would mean commercial flight operations. That is, so long as the aircraft was carrying passengers or freight in a commercial activity, it would be serving its “purpose.”

The estimated economic life of leased property is not necessarily the same as the property’s depreciable life. Depreciable life is the estimated useful life to the existing user of the asset; estimated economic life may involve other users. For example, an automobile may have a total economic life of eight to ten years, but only a three-year depreciable life if the intent of the existing user is to sell or trade the automobile at the end of three years.

2.8

Residual value / unguaranteed residual value

Excerpt from Accounting Standards Codification

Estimated Residual Value

The estimated fair value of the leased property at the end of the lease term.

Unguaranteed Residual Value

The estimated residual value of the leased property exclusive of any portion guaranteed by the lessee or by a third party unrelated to the lessor. A guarantee by a third party related to the lessee shall be considered a lessee guarantee. If the guarantor is related to the lessor, the residual value shall be considered as unguaranteed.

See Section 2.9.2 for discussion of residual values guaranteed by the lessee, Section 2.9.3 for discussion of residual values guaranteed by a third party unrelated to the lessor and Section 5 for discussion of lessor accounting for any unguaranteed residual value in a sales-type or direct financing lease.

2.9

Minimum lease payments**Excerpt from Accounting Standards Codification****Leases – Overall***Recognition***840-10-25-4**

This guidance addresses what constitutes minimum lease payments under the minimum-lease-payments criterion in paragraph 840-10-25-1(d) from the perspective of the lessee and the lessor. 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. (Example 6 [see paragraph 840-10-55-38] illustrates this guidance.) However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception; 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. (Example 7 [see paragraph 840-10-55-39] illustrates this guidance.)

840-10-25-5

For a lessee, minimum lease payments comprise the payments that the lessee is obligated to make or can be required to make in connection with the leased property excluding both of the following:

- a. Contingent rentals
- b. Any 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.

840-10-25-6

If the lease contains a bargain purchase option, only the minimum rental payments over the lease term and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include all of the following:

- a. The minimum rental payments called for by the lease over the lease term.
- b. Any guarantee by the lessee (including by a third party related to the lessee) of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property. If 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 of the residual value. If the lessee agrees to make up any deficiency below a stated amount in the lessor's realization of the residual value, the residual value 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. Note, that the definition of lease term 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 lease inception, 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.

- d. Payments made before the beginning of the lease term. Such payments shall be considered as part of minimum lease payments and included in the 90 percent test, as specified in paragraph 840-10-25-1(d), at their future value at the beginning of the lease term—that is, to give effect to the time value of money, the future value at the beginning of the lease term of the lease payments would be calculated just as payments during the lease term are discounted back to the beginning of the lease term for purposes of applying the 90 percent test in that paragraph. The lessee shall use the same interest rate to accrete payments to be made before the beginning of the lease term that it uses to discount lease payments to be made during the lease term.
- e. Fees that are paid by the lessee to the owners of the special-purpose entity for structuring the lease transaction. Such fees shall be included as part of minimum lease payments (but shall not be included in the fair value of the leased property) for purposes of applying the 90 percent test in paragraph 840-10-25-1(d).

840-10-25-7

For a lessor, minimum lease payments comprise the payments described in paragraphs 840-10-25-5 through 25-6 for a lessee plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee or the lessor, provided the third party is financially capable of discharging the obligations that may arise from the guarantee.

2.9.1 Minimum lease payments

The amount of minimum lease payments is the sum of:

1. The minimum rental payments over the lease term (see Section 2.6 for definition).
2. The amount of any bargain purchase option (see Section 2.4), or, if there is no such option:
 - a. The amount of any guarantee by the lessee (or a third party related to the lessee) of the residual value at the expiration of the lease term (this amount is included whether or not it constitutes a purchase of the property). See Section 2.9.2 for a discussion of residual value guarantees.
 - b. The amount of the payment that must be made if the lease is not renewed or extended at the expiration of the lease term, provided the lease term (see Section 2.6) does not include any renewal periods because this payment appeared to reasonably assure renewal of the lease (this amount is included whether or not it constitutes a purchase of the property).
3. In addition, for lessors, the amount of any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee or the lessor, if the third party is financially capable of discharging its obligation. See Section 2.9.3 for a discussion of a guarantee of the residual value or rental payments by a third party.

A guarantee by the lessee of a lessor's debt is not included in minimum lease payments unless it is in substance a residual value guarantee (see Section 2.9.2.6).

The terms of some lease agreements require that the lessee pay fees for structuring the lease transaction or arranging lessor financing, sometimes referred to as structuring or administrative fees. All fees paid by the lessee to the owners or the lessor (or on behalf of the owners or the lessor) for structuring, administration or any other purpose (other than payments to third parties unrelated to the lessor or lessee for the purchase of residual value insurance as noted in Section 2.9.2.3) would be included as part of minimum lease payments (but not included in the fair value of the leased property) for purposes of applying the 90% recovery criterion described in ASC 840-10-25-1(d) (see Section 3.2).

2.9.1.1 Payments made by lessee prior to beginning of lease term

Payments made prior to the beginning of the lease term (see Section 2.6) are considered minimum lease payments and included in the 90% of fair value recovery test, as specified in ASC 840-10-25-1(d) (see Section 3.2). The amount included in minimum lease payments is based on the future value of the payments at the beginning of the lease term (that is, to give effect to the time value of money). The lessee should use the same interest rate to accrete payments to be made prior to the beginning of the lease term that it uses to discount lease payments to be made during the lease term. If the lease is classified as an operating lease, the lessee should consider the payments made prior to the beginning of the lease term to be prepaid rent. A lessee should recognize its total rental costs associated with an operating lease over the term of the lease as required by ASC 840-20-25, that is, generally on a straight-line basis over the term of the lease. See Section 4.3 for further discussion of operating lease accounting.

2.9.1.2 Impact of executory costs on minimum lease payments

The definition of minimum lease payments excludes amounts for executory costs (e.g., maintenance, taxes and insurance), and any profit thereon, that will be paid to the lessor. All of the calculations required by ASC 840 (e.g., present value for capitalizing a lease) require that executory costs paid to the lessor be subtracted. When lease agreements do not specify the amounts for executory costs, such costs should be estimated.

Illustration 2-5: Determining minimum lease payments for a lease with executory costs

Company X is leasing a photocopier for 3 years at a cost of \$100 per month. The lease agreement provides for “free” on-site maintenance. Typically, the lessor charges \$25 a month to provide on-site maintenance. As a result, the minimum lease payment in this example would be \$75 per month. The remaining \$25 per month represents executory costs included in the lease agreement.

2.9.1.3 Non-performance covenants

Excerpt from Accounting Standards Codification

Leases – Overall

Overview and Background

840-10-05-8

Some lease agreements contain default provisions that are unrelated to the lessee's use of the property, such as financial covenants (for example, maintenance of certain financial ratios related to the financial condition of the lessee). The remedies for default might include the right of the lessor to put the property to the lessee or a requirement that the lessee make a payment to the lessor. See related guidance beginning in paragraph 840-10-25-13.

Recognition

840-10-25-14

Default covenants related to nonperformance do not affect lease classification if all of the following conditions exist:

- a. The default covenant provision is customary in financing arrangements.
- b. The occurrence of the event of default is objectively determinable (for example, subjective acceleration clauses would not satisfy this condition).
- c. Predefined criteria, related solely to the lessee and its operations, have been established for the determination of the event of default.

- d. It is reasonable to assume, based on the facts and circumstances that exist at lease inception, that the event of default will not occur. In applying this condition, it is expected that entities would consider recent trends in the lessee's operations.

If any of those conditions do not exist, then the maximum amount that the lessee could be required to pay under the default covenant shall be included in minimum lease payments for purposes of applying paragraph 840-10-25-1(d).

Non-performance-related default provisions include financial covenants (for example, maintenance of certain financial ratios) related to the financial condition of the lessee.

Non-performance-related default covenants do not affect minimum lease payments when all of the following conditions exist:

1. The default covenant is customary in financing arrangements.
2. The occurrence of the event of default is objectively determinable (subjective acceleration clauses would not satisfy this condition nor would other default covenants based on subjective determinations such as material, reasonable, significant, etc.).
3. Pre-defined criteria, related solely to the lessee and its operations, have been established for the determination of the event of default.
4. It is reasonable to assume, based on the facts and circumstances that exist at the inception of the lease (see Section 2.2), that the event of default will not occur.

If any one of the four conditions is not met, then the maximum amount that the lessee could be required to pay under the default covenant should be included in minimum lease payments.

In applying condition (2), an entity should carefully consider whether a lease contains a default provision based on objective determinations. For example, a lease agreement may contain a material adverse change (MAC) clause that allows the lessor to make its own determination if a MAC has occurred. Upon declaration, the lessor can demand remedies from the lessee (e.g., require a payment from the lessee, allow the lessor to put the asset to the lessee). At the 2011 AICPA National Conference on Current SEC and PCAOB Developments (2011 AICPA Conference), the SEC staff emphasized that remedies for events of default under material adverse change clauses must be included in the minimum lease payment calculation for purposes of lease classification. In such circumstances, the probability that such an event of default will occur is not relevant to this determination.

In applying condition (4), it is expected that entities would consider recent trends in the lessee's operations. In addition, the events that could result in a default should generally be within the control of the lessee in order to conclude that it is reasonable that the event of a default will not occur. For example, an event of default triggered by a change in control generally does not comply with the four conditions noted above, as it is not generally within the lessee's control to assert that it is reasonable to assume that the default will not occur.

It is important to note that the existence of cross default provisions in a lease agreement effectively incorporates covenants of the other loan or lease agreements into the lease being tested. As a result, to the extent a cross default provision incorporates a non-performance covenant from another agreement, the maximum amount the lessee could be required to pay under the lease if the cross default were triggered should be included in minimum lease payments.

Measurement of capital lease obligations

While the SEC staff has been clear that MAC non-performance covenants (and other covenants based on subjective determinations) should be included in minimum lease payments for classification purposes, the SEC staff acknowledged that ASC 840 is less clear about the role of probability when initially measuring a capital lease obligation. At the 2011 AICPA Conference, the SEC staff noted some believe probability should not affect the determination of minimum lease payments used to recognize the capital lease obligation. That is, the maximum amount the lessee could be required to pay under a non-performance-related default covenant should be used to measure the capital lease obligation. The SEC staff observed that others believe probability should be considered and reassessed at each reporting period. The SEC staff stated that it has not objected to either approach, however it has required appropriate disclosure about the determination of the lease obligation. We believe the selection of one of these approaches represents an accounting policy election that should be followed consistently, in accordance with the requirements of ASC 250.

2.9.1.4

Indemnifications for environmental contamination

Excerpt from Accounting Standards Codification

Leases – Overall

Overview and Background

840-10-05-7

Some lessors have required that the lessee indemnify them or their lenders against loss or damage arising from environmental contamination caused by the lessee during the term of the lease, as well as from preexisting environmental contamination (that is, contamination that occurred before lease inception). In some situations, the lessor might have the right to put the property to the lessee under those circumstances. See related guidance beginning in paragraph 840-10-25-13.

Recognition

840-10-25-12

A provision that requires lessee indemnifications for environmental contamination caused by the lessee during its use of the property over the term of the lease would not affect the lessee's classification of the lease.

840-10-25-13

However, if the terms of the lease agreement require that the lessee indemnify the lessor or its lenders for preexisting environmental contamination, then the lessee shall assess at lease inception the likelihood of loss (before consideration of any recoveries from third parties) pursuant to that indemnification provision based on enacted environmental laws and existing regulations and policies in determining whether it should be considered the owner of the property. If the likelihood of loss is remote, then the indemnity would not affect the lessee's classification of the lease. However, paragraph 840-40-15-2 states that, if the likelihood of loss is at least reasonably possible, then the lessee would be considered to have purchased, sold, and then leased back the property and the transaction would be subject to the sale-leaseback provisions of Subtopic 840-40.

A provision that requires lessee indemnifications for environmental contamination caused by the lessee during its use of the property (real estate) over the term of the lease would not affect the lessee's classification of the lease. However, if the terms of the lease agreement require that the lessee indemnify the lessor or its lenders for preexisting environmental contamination, then the lessee would need to assess at the inception of the lease (see Section 2.2) the likelihood of loss (before consideration of any recoveries from third parties) pursuant to that indemnification provision based on enacted environmental

laws and existing regulations and policies in determining whether it should be considered the owner of the property. If the likelihood of loss is remote, then the indemnity would not affect the lessee's classification of the lease. However, if the likelihood of loss is at least reasonably possible (i.e., the chance of occurring is more than remote), then the lessee would be considered to have purchased, sold, and then leased back the property, and the transaction, if real estate, would be subject to the applicable sale-leaseback provisions (see Section 9).

An indemnity for preexisting environmental contamination is within the scope of the provisions of ASC 460, *Guarantees*, unless the indemnity and resultant sale-leaseback accounting results in the lessee having the asset on its books (failed sale-leaseback) or the indemnity is included in minimum lease payments (e.g., a probable preexisting environmental liability). While an indemnity that requires the lessee to indemnify the lessor or lenders for environmental contamination that could occur during the lessee's occupation of the property will not be included in the analysis of whether the lease is a sale-leaseback, it may be subject to the provisions of ASC 460. If the indemnification is for environmental contamination that could occur as a result of the lessee's own actions, then the indemnity is excluded from the requirements of ASC 460 as it represents a guarantee of the lessee's own performance. However, in the event that the indemnity is broad and requires the lessee to indemnify the lenders or lessor for the actions of others (e.g., contamination from a neighboring property), the indemnity is generally subject to the provisions of ASC 460 and should be accounted for at fair value. See Section 4.3.6 for a review of the accounting for guarantees, including indemnifications, under ASC 460.

2.9.1.5 Non-traditional lease payments

Certain lease agreements include lease payments that increase based on a multiple of a change in an index (e.g., the consumer price index) with a cap. Questions arise as to whether this feature should be viewed as a contingent rental, a derivative or included in minimum lease payments at the capped amount. An example would be a lease of a retirement community where lease payments increase each year by the lesser of 3% or 3 times the annual increase in the consumer price index (CPI). As discussed in ASC 840-10-25-4 (see Section 2.13), lease payments that depend on an existing index, such as CPI, should be included in minimum lease payments based on the index at the inception of the lease (see Section 2.2) with any increases or decreases in lease payments that result from subsequent changes in the index reflected as they occur. However, the function of an index multiplier and a cap serves to significantly modify the arrangement from one in which the lease payments simply vary based on an index rate. Often the combination of the multiplier and cap are specifically designed to assure that the cap is always reached.

We believe that lessees and lessors should evaluate provisions in lease arrangements that require an adjustment to lease payments based on a multiple of an index and a cap and determine whether these provisions represent, in substance, de facto minimum lease payments. If the contingent rent feature represents de facto minimum lease payments (i.e., the increase in the index coupled with the multiplier and cap effectively assures the cap will be reached each year), the capped payments should be considered minimum lease payments because, in substance, the additional payments do not represent contingent rent. This accounting, which applies to both lessors and lessees, affects minimum lease payments not only for purposes of the 90% test but also the lessor and lessee accounting for straight-line rent (subject to collectibility) under an operating lease. To the extent the lessee or lessor determines that the index multiplier and cap do not represent de facto minimum lease payments, evaluation under the embedded derivative guidance of ASC 815-15 would likely conclude that inflation-indexed rentals that are subject to a leverage factor (e.g., 3 times the change in CPI) do not qualify for the clearly and closely related exception and, as a result, would be required to be separated from the host contract (the lease) and accounted for as a derivative. The initial fair value of such derivative would be treated as a day one minimum lease payment with subsequent changes in fair value accounted for under the applicable guidance in ASC 815, *Derivatives and Hedging*. See Section 2.13 for further details.

The following example illustrates the accounting for de facto minimum lease payments:

Illustration 2-6: De facto minimum lease payments

Company A leases a building for five years with a fair value of \$100 from Lessor B. The lease agreement provides that the lease payments that start at \$10 annually are adjusted based on 3 times the annual increase in CPI (limited to an aggregate annual adjustment of 3%). We believe that in substance, Company A has agreed, at lease inception, to pay Lessor B additional lease payments in the amount of 3% per year. As a result, the 3% increase represents de facto minimum lease payments and, if the lease is classified as an operating lease, the annual 3% increase would be included in the straight-line rental calculation.

The following would be the straight-line rent calculation for both the lessee and lessor:

Year	Minimum lease payments	Straight-line rental revenue/expense ¹
1	\$10.00	\$ 10.62
2	\$10.30 (\$10.00 x 1.03)	\$ 10.62
3	\$10.61 (\$10.30 x 1.03)	\$ 10.62
4	\$10.93 (\$10.61 x 1.03)	\$ 10.62
5	\$11.26 (\$10.93 x 1.03)	\$ 10.62

¹ If the multiplier of CPI were considered a derivative instead of de facto minimum lease payments (at the capped amount), the day one fair value of the derivative would be included as a minimum lease payment for purposes of determining straight-line rent (as well as assessing the 90% test).

2.9.1.6

Lessee's obligations for asset retirement obligations (AROs)

Excerpt from Accounting Standards Codification

Leases – Overall

Relationships

840-10-60-1

For asset retirement obligations of a lessee that exist in connection with leased property (whether imposed by a lease agreement or by a party other than the lessor) and that do not meet the definition of either minimum lease payments or contingent rentals in paragraph 840-10-25-4, see Subtopic 410-20.

It is important to remember that the requirements of ASC 410-20, *Asset Retirement Obligations*, may apply not only to long-lived assets owned by the company but also to improvements made to leased assets. The following is a discussion of the lessee's obligations for asset retirement obligations.

Distinguishing an ARO from minimum lease payments and contingent rentals

The provisions of ASC 410-20 do not apply to obligations of a lessee in connection with leased property, whether imposed by a lease agreement or by a party other than the lessor, that meet the definition of either minimum lease payments or contingent rentals. Instead, obligations that are considered either minimum lease payments or contingent rentals should be accounted for in accordance with ASC 840. However, obligations imposed by a lease agreement that meet the definition of an ARO and do not meet the definition of minimum lease payments or contingent rentals are accounted for by the lessee in accordance with the requirements of ASC 410-20. It should be noted that ASC 840 does not apply to leases to explore or exploit natural resources, thus any retirement obligations imposed by these types of agreements always are within the scope of ASC 410-20.

Minimum lease payments are the payments that the lessee is obligated to make or can be required to make in connection with the leased property. This definition has been interpreted fairly broadly to cover not only monies that are required to be paid to the lessor but also obligations imposed on the lessee under the lease that may be paid to third parties. The estimated costs imposed by a lease requiring a lessee to dismantle and remove a leased asset at the end of the lease term are recognized as a component of minimum lease payments. By including the removal costs in minimum lease payments, the estimated removal costs will be accrued over the term of an operating lease (on a basis such that rent expense consisting of both cash payments and accrual of the estimated removal costs is recognized on a straight-line basis over the lease term). On termination of an operating lease, the liability for removal costs is fully recognized. In a capital lease the estimated removal costs are included in the capital lease obligation.

Contingent rentals are defined as the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease (see Section 2.2) in the factors (other than the passage of time) on which lease payments are based. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. Increases or decreases in lease payments that result from contingent rentals are included in income as accruable.

Obligations imposed by a lease agreement to return a leased asset to its original condition (if it has been modified by the lessee) generally do not meet the definition of a minimum lease payment or a contingent rental and, therefore, should be accounted for by the lessee as an ARO. Said another way, if an improvement to leased property has been recognized as an asset on the lessee's balance sheet (leasehold improvements), any obligation to remove that improvement on expiration of the lease should generally be accounted for as an ARO. For example, a lessee who leases retail space and installs its own improvements (e.g., customized décor and logo) would have an obligation to remove the improvements at the expiration of the lease. The obligation to remove the leasehold improvements does not arise solely because of the lease but instead is a direct result of the lessee's decision to modify the leased space. Such costs would be excluded from minimum lease payments and contingent rentals.

In certain circumstances, it may be difficult to determine whether improvements are assets of the lessee or the lessor. In many cases the conclusion, which can affect the determination as to whether removal costs should be accounted for under the provisions for accounting for leases (ASC 840) or the provision for AROs (ASC 410-20), will be facts and circumstances based. Guidance to assist in determining whether improvements should be considered assets of the lessee or the lessor can be found in ASC 840-40-55-2 through 55-16. Sections 4.3.5.2 and 10 of this publication also discuss factors to consider in making this determination.

The following illustrations demonstrate the concepts discussed above.

Illustration 2-7: Obligation as a result of lease contract

Land with cellular tower

Entity A (lessee) leases vacant land from Entity B (lessor). Entity A has the right but not the obligation to construct a cellular tower on the property. If Entity A does construct the cellular tower on the property, it is obligated to return the land to its original condition at the end of the lease term. In this case, it is not the lease of the land that imposes the liability on Entity A, but instead it is the construction of the cellular tower. If Entity A does not construct the cellular tower, it has no obligation under the lease. If it does construct the cellular tower, the tower would be recognized as a leasehold improvement and the obligation to remove the tower would be an ARO.

Alternatively, if Entity A leases land and an existing cellular tower from Entity B and is required to demolish and remove the cellular tower at the end of the lease term, Entity A has assumed a direct obligation related to the leased asset that arises upon entering into the lease (versus an obligation created by some future action). As a result, the demolition and removal costs should be included in minimum lease payments. By including the retirement obligation in minimum lease payments, the retirement obligation will be accrued over the term of the operating lease (on a basis such that rent expense consisting of both cash payments and accrual of the retirement obligation is recognized on a straight-line basis over the lease term) such that, on termination of the lease, a liability exists that would be reduced by the payments made to demolish and remove the cellular tower.

Lease of office space

A lessee leases office space with pre-existing improvements (e.g., interior walls and carpeting) and is contractually obligated to remove these improvements upon expiration of the lease. Because the original condition of the leased space included the improvements and the lessee is leasing the space and improvements, the estimated removal obligation should be included in minimum lease payments.

Alternatively, if the lessee pays to build out the space to configure it to its needs (e.g., interior walls and carpeting) and is required to remove the improvements on expiration of the lease, it should account for the removal obligation as an ARO. The lessee is obligated to remove an asset that it constructed and recorded as an asset (i.e., leasehold improvement).

If the lessee leases office space with both pre-existing improvements (i.e., lessor assets) and additional leasehold improvements that it constructs, estimated costs to remove the improvements should be split between the pre-existing improvements and the constructed improvements. Estimated costs to remove the pre-existing improvements should be included in minimum lease payments. The contractual obligation associated with the removal of the leasehold improvements constructed by the lessee should be accounted for as an ARO.

Illustration 2-8: Obligation as a result of a legal obligation

Entity A (lessor) owns a gas station that it leases to Entity B (lessee). The property includes pre-existing underground fuel storage tanks.

Scenario 1

At the inception of the lease, there is a legal requirement to remove the pre-existing underground fuel storage tanks in ten years. Even though Entity A leases the gas station to another party, it remains legally obligated for removal of the underground storage tanks and must recognize an ARO.

If the lease agreement requires Entity B to remove the underground storage tanks at the end of the lease term, the cost of removal would be included in the minimum lease payments by Entity B and would have no effect on the requirement for Entity A to recognize an ARO under ASC 410-20 for its obligation under the local statute.

Scenario 2

At the inception of the lease, there is no legal requirement for removal of the underground storage tanks. However, the lease requires that if such a legal requirement is enacted during the lease term, Entity B is required to remove the underground storage tanks at the end of the lease.

Recognition of an ARO by Entity A for an obligation to remove the underground storage tanks would be required on the date any such legal requirement was enacted. The entity may not anticipate the enactment of a new law in determining whether or not to recognize a liability for the obligation.

Whether the estimated costs of removal of the underground storage tanks would be accounted for by Entity B as a contingent rental at the inception of the lease or as a minimum lease payment would be a decision based on the facts and circumstances. If the enactment of a law requiring removal of the underground storage tanks during the lease term was judged to be probable at inception of the lease, the removal costs would be included in the minimum lease payments and accounted for under the general provisions for accounting for leases under ASC 840. However, if the enactment of such a law was not judged to be probable at lease inception, the estimated removal costs would be accounted for as a contingent rental. If a legal requirement to remove the underground storage tanks was enacted during the lease term or it was determined that the enactment of such law was probable, Entity B would accrue the estimated costs of removal.

As noted above, an obligation to return a leased asset to its original condition (if it has been modified by the lessee) is an ARO that should be accounted for under ASC 410-20. In certain cases, settlement of the obligation may be planned prior to the end of the contractual term of the lease. However, a plan to voluntarily settle an ARO obligation prior to the contractual term of the lease does not affect the requirement to record an ARO liability when leasehold improvements are made.

Illustration 2-9: Settlement of ARO prior to the end of the lease term

A retailer signs a ten-year lease for space in a shopping mall. The lease terms include a requirement for the lessee to return the space to its original condition at the end of the lease. At the inception of the lease, the retailer modifies the space by constructing various leasehold improvements (e.g., merchandise displays, shelving to stock merchandise, flooring, check-out counters). The retailer estimates that the useful life of the improvements is five years, at which time they will all be replaced.

The obligating event to remove these leasehold improvements occurs when they are made, regardless of whether settlement is planned at the end of the contractual lease term or at an earlier point in time. The asset retirement cost should be amortized over the five-year estimated useful life of the improvements and the obligation should be accreted using the credit-adjusted risk-free rate over the same five-year term. If the retailer replaces the original leasehold improvements after five years, a settlement of the original ARO obligation should be recognized and a new ARO obligation should be recorded related to any newly constructed leasehold improvements.

See our Asset retirement obligations FRD for further discussion on the accounting for asset retirement obligations, including further discussion regarding the effect of applying the provisions of ASC 820, *Fair Value Measurement*, to the measurement of asset retirement obligations.

2.9.2

Residual value guarantee

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-8

For guidance on the scope application of Topic 460 to residual value guarantees, see paragraph 460-10-15-7(b). For guidance on the consideration of residual value guarantees when applying the minimum-lease-payments criterion in classifying a lease, see the guidance beginning in paragraph 840-10-55-8.

840-10-25-9

A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals in that the amount is not determinable at the inception of the lease. Such a provision does not constitute a lessee guarantee of the residual value for purposes of paragraph 840-10-25-6(b).

Implementation Guidance and Illustrations**840-10-55-8**

This implementation guidance addresses consideration of residual value guarantees when applying the minimum-lease-payments criterion in classifying a lease.

840-10-55-9

If a lease limits the amount of the lessee's obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessee's guarantee to be included in minimum lease payments under paragraph 840-10-25-6(b) shall be limited to the specified maximum deficiency the lessee can be required to make up. In other words, the stated amount referred to is the specified maximum deficiency that the lessee is obligated to make up. If that maximum deficiency clearly exceeds any reasonable estimate of a deficiency that might be expected to arise in normal circumstances, the lessor's risk associated with the portion of the residual in excess of the maximum may appear to be negligible. However, the fact remains that the lessor must look to the resale market or elsewhere rather than to the lessee to recover the unguaranteed portion of the stipulated residual value of the lease property. The lessee has not guaranteed full recovery of the residual value, and the parties should not base their accounting on the assumption that the lessee has guaranteed it. The 90 percent test specified in paragraph 840-10-25-1(d) is stated as a lower limit rather than as a guideline.

840-10-55-10

A guarantee of the residual value obtained by the lessee from an unrelated third party for the benefit of the lessor shall not be used to reduce the amount of the lessee's minimum lease payments under paragraph 840-10-25-6(b) except to the extent that the lessor explicitly releases the lessee from obligation, including secondary obligation if the guarantor defaults, to make up a residual value deficiency. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessee's minimum lease payments.

ASC 840-10-25-6(b) (see Section 2.9) requires minimum lease payments to include any guarantee by the lessee (including a guarantee by a third party related to the lessee) of the residual value at the expiration of the lease term (see Section 2.6), whether or not payment of the guarantee constitutes a purchase of the leased property. In addition, guarantees of residual value are included in minimum lease payments without regard to either the likelihood of the payment of such guarantee or the leased asset's estimated fair value at the time the payment under the guarantee is determined.

Residual guarantees often are included in automobile lease agreements, and, in many cases, the amount used as the residual guarantee in determining minimum lease payments is critical in determining the classification of the lease for both the lessee and lessor.

The following illustration demonstrates this concept.

Illustration 2-10: Effect of residual value guarantee on lease classification

Assume:

Lease term	3 years
Economic life	5 years
Fair value	\$ 8,000
Present value of lease payments	\$ 6,500
Present value of residual value	\$ 1,000

	90% Test	
	If residual guaranteed	If residual not guaranteed
Present value of lease payments	\$ 6,500	\$ 6,500
Present value of residual value	<u>1,000</u>	<u>—</u>
Present value of minimum lease payments	\$ 7,500	\$ 6,500
90% of fair value	\$ 7,200	\$ 7,200
Lease classification	Capital	Operating

2.9.2.1 Residual value guarantees as derivatives

ASC 840-10-15-20 addresses the interaction between ASC 840 and ASC 815, *Derivatives and Hedging*.

Excerpt from Accounting Standards Codification**Leases – Overall****Scope and Scope Exceptions****840-10-15-20**

Paragraph 815-10-15-79 explains that leases that are within the scope of this Topic are not derivative instruments subject to Subtopic 815-10, although a derivative instrument embedded in a lease may be subject to the requirements of Section 815-15-25. Paragraph 815-10-15-80 explains that residual value guarantees that are subject to the guidance in this Topic are not subject to the guidance in Subtopic 815-10. Paragraph 815-10-15-81 requires that a third-party residual value guarantor consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in that Subtopic.

Leases are not considered derivatives and are not subject to the accounting for derivative instruments under ASC 815-10. However, a lease may contain an embedded derivative which could be subject to the requirements of ASC 815-15-25.

Residual value guarantees that are subject to the requirements of the lease accounting literature are not subject to the requirements for derivative instruments under ASC 815. This “exception” only applies to residual value guarantees within the scope of the leasing literature (ASC 815-10-15-80). A residual value guarantee obtained by a lessee (or lessor) or provided at a point in time after the inception of the lease (see Section 2.2) would not be subject to ASC 840 and thus would be subject to derivative accounting under ASC 815 if the guarantee met the definition of a derivative and did not qualify for any of the scope exceptions therein.

In addition, ASC 460 affects the way that companies account for residual value guarantees in operating leases.¹ Under the applicable accounting guidance for guarantees in ASC 460, the guarantor (e.g., the lessee that provides the residual value guarantee) is required to recognize a liability for the obligation at its fair value at the inception of the guarantee. See Section 4.3.6 for a review of the accounting for residual value guarantees in operating leases.

2.9.2.2 **Residual value guarantee of deficiency that is attributable to damage, extraordinary wear and tear or excessive usage**

Lease provisions often require the lessee to make up a residual value deficiency attributed to damage, extraordinary wear and tear, or excessive usage (e.g., excessive mileage on a leased vehicle). These lease provisions do not constitute a guarantee of residual value by the lessee but are similar to contingent rentals in that the amounts are not determinable at the inception of the lease. Thus, they are not included in minimum lease payments (ASC 840-10-25-9 – see Section 2.9.2).

2.9.2.3 **Third party insurance that guarantees the asset's residual value**

Lessees often guarantee the residual value and obtain an offsetting guarantee from an unrelated third party (e.g., an insurance company). A third party guarantee can be used as a basis to reduce the lessee's minimum lease payments only when (and to the extent) the lessor explicitly releases the lessee from the residual value guarantee (including a secondary obligation if the guarantor defaults). Amounts paid to the unrelated third party as consideration for the guarantee are executory costs and are not included in the lessee's minimum lease payments (ASC 840-10-55-10 – see Section 2.9.2). If the lessee is not removed as the primary or secondary guarantor under the lease by the lessor, the guaranteed residual value should be included in minimum lease payments. In addition, if the lessee is not removed as the primary or secondary guarantor under the lease by the lessor, then the residual value guarantee is subject to the provisions of ASC 460 and should be accounted for at fair value by the lessee if the lease is classified as an operating lease. See Section 4.3.6 for a review of the accounting for residual value guarantees.

2.9.2.4 **Guarantee of residual value deficiencies**

Certain lease agreements limit the lessee's guarantee to an amount less than the stipulated residual value but clearly in excess of any reasonable estimate of a deficiency that might be expected in normal circumstances. In these situations the amount of the lessee's guarantee that should be included in the minimum lease payments is the maximum guarantee, even if that amount exceeds any reasonable estimate of the expected deficiency. The stipulated residual value in excess of the guaranteed amount is considered unguaranteed residual value for which the lessor is at risk (ASC 840-10-55-9 – see Section 2.9.2).

Illustration 2-11: Guarantee of residual value deficiency included in minimum lease payments

Assume the same facts as Illustration 2-10, except that the lessee guarantees a residual value of \$100 at the end of the lease term (the expected residual value at the end of the lease term is \$1,000). Even though this contingency may seem remote, the amount included in minimum lease payments would be \$100. The lease would be classified as an operating lease because the sum of the present values of the lease payments (\$6,500) and residual value (\$100) is less than 90% of the fair value.

¹ Note that ASC 460-10-15-7(b) excludes residual value guarantees that pertain to property or equipment under a capital lease from the scope of ASC 460. This scope exception exists because the lessee already includes its obligation under the guarantee contract in the calculation of its obligation under the capital lease; therefore, the obligation is already reflected in the lease obligation recorded on the lessee's books.

As noted in Section 2.9.2.1, lessee guarantees of residual value under an operating lease are subject to the provisions of ASC 460. See Section 4.3.6 for a review of the accounting for residual value guarantees.

2.9.2.5 Residual value guarantee of a group of assets

In certain master lease agreements covering a group of assets, the lessee guarantees the residual value of the group of assets being leased as opposed to the residual value of each individual asset in the group. Although other methods of allocation might be appropriate, allocating the maximum residual value guarantee among all of the leased assets on a pro rata basis in relation to the expected residual value at the end of the lease term (see Section 2.6) of each asset would be appropriate if the lease term is coterminous. For instance, if the group residual value guarantee is \$180 and the total expected residual values of all of the leased assets as of the end of the master lease term is \$300, the residual value guarantee would be allocated to each asset based on 60% of each leased asset's expected residual value.

As noted above, residual value guarantees in operating leases are subject to the provisions of ASC 460. See Section 4.3.6 for a review of the accounting for residual value guarantees.

2.9.2.6 Impact of lessee loans or guarantees of lessors' debt on residual value guarantees

In accordance with ASC 840-10-25-6 (see Section 2.9), a guarantee by a lessee of a lessor's debt is not included in minimum lease payments; however, to the extent that the lessor's debt is recourse only to the leased asset (either because the debt is non-recourse or the lessor has no significant assets other than the property under lease), a guarantee by the lessee of the lessor's non-recourse debt or a non-recourse loan made by the lessee to the lessor is tantamount to guaranteeing the residual value, and accordingly, such guarantee (the outstanding debt balance at the end of the lease term – see Section 2.6) should be included in the minimum lease payments for the purposes of the 90% test.

2.9.2.7 Lessee guarantee of lessor's return

Certain lease agreements include a provision that on lessee termination of a lease, the lessee is required to make payments to the lessor, or a lender to the lessor, to assure a stated return on the leased property. This termination payment provides the lessor (or third party) a guaranteed return. Any termination payments that could be required to be made would be considered a termination penalty that would be used to determine lease term (see Section 2.6) and might have to be included in minimum lease payments. An obligation to only make up any shortfall on the lessor's return also would be an early termination penalty that would be used to determine lease term and might be included in minimum lease payments (under the assumption that the lessee would be responsible for the full shortfall, regardless of the likelihood of that assumption).

2.9.2.8 Increase in estimated residual value during the lease term

The residual value cannot be increased subsequent to the inception of the lease (see Section 2.2) and cannot exceed the amount estimated at the inception of the lease except as follows. 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.

2.9.3 Third party guarantee of lease payments or residual value

For lessors, in addition to lessee guarantees of residual value (primary or secondary), the amount of any guarantee of the residual value or rental payments beyond the lease term (see Section 2.6) by a third party unrelated to the lessee or lessor is included in minimum lease payments for determining the

classification of a lease. As noted in Section 2.9.2.3, a lessee can exclude third party residual value guarantees from minimum lease payments for purposes of determining lease classification, only if the lessor has released the lessee from primary and secondary liability. As a result, the purchase of a third party guarantee often results in lessors obtaining sales-type or direct finance lease treatment when the lease would otherwise be classified as an operating lease.

In considering residual value guarantees, it is important to understand the contract's terms prior to including the guaranteed residual value in the lessor's minimum lease payments for purposes of determining the lease classification. In many cases, the guarantee will contain provisions that result in the exclusion of the guarantee from the minimum lease payments. Some of these provisions are described below.

Exclusion provisions

In some cases, third party residual value insurance contracts contain exclusion provisions such that the contract does not represent a guarantee of the lessor's residual value (that is, the residual value guarantee is only effective in limited circumstances). Many of the customary exclusion provisions, such as excess wear and tear or damages (which are typically the lessee's responsibility) would be acceptable and not preclude consideration of the guaranteed residual value in the lessor's minimum lease payments for classification purposes. However, exclusion provisions that substantially curtail the lessor's ability to receive a payment from the guarantor on disposition of the leased asset at the end of the lease term (see Section 2.6) would prevent the lessor from including the guaranteed residual value in the minimum lease payments due under the terms of the lease. For example, a requirement that the lessor return the leased asset to "like-new" condition at the end of the lease would not represent an effective guarantee of the asset's residual value. Likewise, a requirement that the leased asset be returned to a location that is economically unfeasible based on the anticipated location of the leased asset and transportation costs to the specified location at the end of the lease term, or other requirements that severely restrict the lessor's ability to dispose of the asset at or near market value at the end of the lease term, should be carefully evaluated.

Guarantees of residual value of a portfolio of assets

In some cases, the residual value insurance may be for a portfolio of assets as opposed to individual assets within the lease portfolio. Accordingly, when an asset has a residual value below the guaranteed amount, such deficiency could be offset by assets that have residual values in excess of their guaranteed value. In May 2003, the SEC issued a staff announcement entitled, *Lessor Consideration of Third-Party Value Guarantees*, which addresses the issue of residual value guarantees for a portfolio of assets for which settlement is not based solely on the residual value of the individual leased assets and is included in ASC 840-30-S99-1. The SEC concluded that residual value guarantees of a portfolio of leased assets preclude a lessor from determining the amount of the guaranteed residual value of any individual leased asset within the portfolio at lease inception, due to the netting of the residual value gains and losses. The SEC therefore concluded that no amounts should be included in minimum lease payments related to the guarantee.

Limit on the aggregate amount of the residual value guarantee

Some third-party residual value guarantee contracts limit the amount of coverage provided on a portfolio of assets. For example, an insurance contract may guarantee the residual value of the individual assets within the portfolio, such that the leases would qualify as direct financing leases if the residual value guarantee were included in the minimum lease payments. However, the insurance contract may also contain a provision that, in the aggregate, the insurance contract will not pay more than 25% of the total residual value of the portfolio of leased assets. As a result of the cap, it is unclear what portion, if any, of an individual asset is guaranteed, resulting in a disqualification of such insurance from minimum lease payments (noteworthy is that the issues noted in the section "Guarantees of residual value of a portfolio of assets" may also be present and result in the disqualification of such insurance).

Deductibles

In some cases, the third party residual value guarantee contract may have a deductible for either the portfolio of assets or each individual asset. The deductible is the responsibility of the lessor and must be met before any payment will be made under the guarantee contract. Third party residual value guarantees that have portfolio deductibles should be excluded in their entirety by the lessor when computing the minimum lease payments for purposes of determining the lease classification because the portfolio deductible precludes the lessor from determining the guaranteed residual value for each individual asset at lease inception (noteworthy is that the issues noted in the section “Guarantees of residual value of a portfolio of assets” may also be present and result in the disqualification of such insurance).

In the event that the third-party residual value guarantee contract has a deductible on each individual asset within the portfolio, the guaranteed residual value in excess of the deductible may be included in the lessor’s minimum lease payments for purposes of determining the lease classification under ASC 840-10-25.

Self-insurance and premiums based on loss experience

The residual value guarantee must be from a third party unrelated to the lessor. In the event that the guarantee is from a related party, the residual value is not guaranteed and should be excluded from the lessor’s minimum lease payments for purposes of determining lease classification. In addition, if the lessor participates in the loss experience, whether directly or indirectly, as would be the case with many retrospective policies (that is, the lessor’s premium is adjusted at the end of the coverage period based on actual loss experience or subsequent premiums are adjusted based on prior policy period losses), the residual values are not guaranteed and should be excluded from the lessor’s minimum lease payments for purposes of determining the lease classification.

As further discussed in Section 2.9.2.1, residual value guarantees that are subject to lease accounting literature (i.e., ASC 840) by lessees and lessors are excluded from the scope of ASC 815, *Derivatives and Hedging*.

2.10

Interest rate implicit in a lease

Excerpt from Accounting Standards Codification

Interest Rate Implicit in the Lease

The discount rate that causes the aggregate present value at the beginning of the lease term of the minimum lease payments (as defined in paragraph 840-10-25-4), excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and the unguaranteed residual value accruing to the benefit of the lessor to be equal to the fair value of the leased property to the lessor at the lease inception, minus any investment tax credit retained by the lessor and expected to be realized by him. 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 its benefit.

The implicit interest rate in a lease is used by the lessor (and to the extent it is determinable by the lessee and lower than the lessee’s incremental borrowing rate, the lessee) to compute the net present value of the minimum lease payments for purposes of determining its appropriate lease classification. By definition the implicit rate is the rate that, when applied to (1) the minimum lease payments and (2) the lessor’s unguaranteed residual value, results in an aggregate present value equal to the fair value of the property at the inception date (see Section 2.2), less any investment tax credit retained and expected to be realized by the lessor. If the lessor is not entitled to any excess amount realized on disposition of the leased asset over a guaranteed amount, no unguaranteed residual value would accrue to the lessor.

It is important to note that the interest rate implicit in the lease is defined in ASC 840 and calculated for purposes of applying lease accounting. It may, and often does, differ from the contractually stated or negotiated interest rate. The following illustrates the computation of the implicit interest rate.

Illustration 2-12: Determining the interest rate implicit in a lease

Assume equipment with a fair value of \$90,832 is leased for 10 years at \$14,500 per year payable at the end of the year. The lessor estimates that the unguaranteed residual value at the end of the lease term will be \$4,500.

The implicit interest rate is the rate that discounts the minimum lease payments and the unguaranteed residual value to \$90,832. In this example, the implicit rate is 10% as shown by the following:

Factor for present worth of \$1 payable in 10 annual payments (10% compounded annually)	6.1446	
Annual rental and net present value	<u>\$ 14,500</u>	\$ 89,097
Factor for present worth of \$1 due in 10 years (10% compounded annually)	0.3855	
Unguaranteed residual and net present value	<u>\$ 4,500</u>	<u>1,735</u>
Fair value		<u>\$ 90,832</u>

2.10.1 Impact of a fixed price purchase option on implicit rate

If a lease contains a fixed price purchase option that is not determined to be a bargain, the maximum amount of the unguaranteed residual value that can be used for purposes of determining the implicit interest rate is the fixed price.

2.11 Incremental borrowing rate

Excerpt from Accounting Standards Codification

Incremental Borrowing Rate

The rate that, at lease inception, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset. This definition does not proscribe the lessee's use of a secured borrowing rate as its incremental borrowing rate if that rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.

The lessee's incremental borrowing rate is the rate that the lessee would have incurred on debt obtained over a similar term for the specific purpose of acquiring the leased asset. The lessee's incremental borrowing rate may be equivalent to a secured borrowing rate if that rate is determinable, reasonable and consistent with the financing that would have been used in the particular circumstances. The lessee's incremental borrowing rate should reflect the effect of any compensating balances or other requirements present in the lease that would affect the lessee's borrowing cost for similar debt. The incremental borrowing rate should also reflect the effect of any third party guarantees of minimum lease payments obtained by the lessee, to the extent that similar guarantees of debt payments would have affected the borrowing costs. However, the lessee's incremental borrowing rate should not include any component related to the lessee's cost of capital (i.e., the incremental borrowing rate should not reflect the effect of lessee's use of a combination of debt and equity to finance the acquisition of the leased asset).

2.11.1 Lessee unable to obtain financing

If the lessee's financial condition is such that third parties generally would be unwilling to provide debt financing, the incremental borrowing rate of the lessee might not be readily determinable. In these rare cases, the lessee should use the interest rate for the lowest grade of debt currently available in the market place as its incremental borrowing rate.

2.11.2 Subsidiaries' incremental borrowing rate

The intercompany rate on loans from the parent to the subsidiary generally should not be used as the lessee's incremental borrowing rate for purposes of classifying a lease. The rate used by the subsidiary should reflect the incremental borrowing rate of the parent, unless the subsidiary is able to obtain financing on a stand-alone basis without the parent or other related entities guaranteeing the debt.

2.11.3 Other factors impacting the lessee's incremental borrowing rate

The lessee's incremental borrowing rate should be based on borrowings in the same currency as the lease payments (e.g., if lease payments are denominated in Euros, the incremental borrowing rate should be based on a Euro borrowing). In addition, to the extent that lease payments vary in accordance with an interest rate index (e.g., prime rate or LIBOR), the incremental borrowing rate should be based on floating rate debt based on the same index.

2.12 Initial direct costs

Excerpt from Accounting Standards Codification

Leases – Operating Leases

Recognition

840-20-25-17

Initial direct costs include only those costs incurred by the lessor that have both of the following characteristics:

- a. They are costs to originate a lease incurred in transactions with independent third parties that meet both of the following conditions:
 1. The costs result directly from and are essential to acquire that lease
 2. The costs would not have been incurred had that leasing transaction not occurred
- b. They are costs directly related to only the following activities performed by the lessor for that lease:
 1. Evaluating the prospective lessee's financial condition
 2. Evaluating and recording guarantees, collateral, and other security arrangements
 3. Negotiating lease terms
 4. Preparing and processing lease documents
 5. Closing the transaction

840-20-25-18

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 any of the following activities performed by the lessor:

- a. Advertising
- b. Soliciting potential lessees
- c. Servicing existing leases
- d. Other ancillary activities related to establishing and monitoring credit policies, supervision, and administration

840-20-25-19

Further, initial direct costs shall not include any of the following:

- a. Administrative costs
- b. Rent
- c. Depreciation
- d. Any other occupancy and equipment costs
- e. Employees' compensation and fringe benefits related to activities described in the preceding paragraph
- f. Unsuccessful origination efforts
- g. Idle time

840-20-25-20

Initial direct cost shall be offset by nonrefundable fees that are yield adjustments as prescribed in Subtopic 310-20.

2.12.1**Lessee accounting for initial direct costs**

Initial direct costs are those costs that are directly associated with consummating a lease (e.g., commission, legal fees, credit checks and preparing and processing documents). If a lessee pays the initial direct costs that are attributable to the lessor (or its lender), such payments would not be considered contingent rent but instead should be included in minimum lease payments. Also included in minimum lease payments would be costs the lessee bears to enhance the credit of the lessee because such enhancements are considered to be made for the benefit of the lessor (e.g., standby letter of credit and credit and title insurance). Payments made by the lessee on behalf of the lessor for residual value insurance are considered executory costs and are not included in the minimum lease payments by the lessee (ASC 840-10-55-10 – see Section 2.9.2). If the lease is classified as an operating lease, the costs paid by the lessee on behalf of the lessor should be deferred and amortized over the term of the lease using the straight-line method (i.e., considered additional rent).

If the lessee incurs its own costs as a result of entering into an operating lease, for example, legal costs, such payment should not be included in minimum lease payments but instead should be deferred and amortized over the lease term (see Section 2.6) using the straight-line method. If the lease is classified as a capital lease, the initial direct costs incurred by the lessee on its own behalf should also be deferred and amortized over the lease term using the straight-line method.

If the lessor pays the lessee's initial direct costs, those costs should be excluded from minimum lease payments by the lessee assuming the reimbursement of those costs is included in minimum lease payments. The portion of the operating lease payments attributable to repayment of the lessee's initial direct costs should be treated as a lease incentive and recorded as a separate asset and obligation, with the asset amortized over the lease term and the obligation reduced by lease payments (see Section 4.3.3 for further details).

2.12.2 Lessor accounting for initial direct costs

As noted in detail in Section 5, initial direct costs incurred by the lessor are expensed as part of the gain on sale in a sales-type lease, capitalized in a direct financing lease and deferred and amortized over the term of an operating lease in proportion to the recognition of rental income over the lease term (see Section 2.6). Additionally, as noted above, if a lessee pays the initial direct costs that are attributable to the lessor (or its lender), such payments should be included in minimum lease payments.

2.13 Contingent rentals

Excerpt from Accounting Standards Codification

Contingent Rentals

The increases or decreases in lease payments that result from changes occurring after lease inception in the factors (other than the passage of time) on which lease payments are based, excluding 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. The term contingent rentals contemplates an uncertainty about future changes in the factors on which leased payments are based.

Leases – Overall

Overview and Background

840-10-05-6A

Some rental agreements provide for minimum rental payments plus contingent rents based on the lessee's operations, such as a future specified sales target.

Recognition

840-10-25-4

This guidance addresses what constitutes minimum lease payments under the minimum-lease-payments criterion in paragraph 840-10-25-1(d) from the perspective of the lessee and the lessor. 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. (Example 6 [see paragraph 840-10-55-38] illustrates this guidance.) However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception; 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. (Example 7 [see paragraph 840-10-55-39] illustrates this guidance.)

840-10-25-35

A lessee shall recognize contingent rental expense (in annual periods as well as in interim periods) before the achievement of the specified target that triggers the contingent rental expense, provided that achievement of that target is considered probable.

Derecognition**840-10-40-1**

Rental expense recorded previously in accordance with paragraph 840-10-25-35 shall be reversed into income at such time that it is probable that the specified target will not be met.

Implementation Guidance and Illustrations**Example 6: Applying the Definition of Contingent Rentals—Rentals Contingent on Factor Related to Future Use****840-10-55-38**

This Example illustrates paragraph 840-10-25-4, which states that lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours or use of sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. Assume that a lease agreement for retail store space stipulates a monthly base rental of \$200 and a monthly supplemental rental of one-fourth of one percent of monthly sales volume during the lease term. Even if the lease agreement is a renewal for store space that had averaged monthly sales of \$25,000 for the past 2 years, minimum lease payments would include only the \$200 monthly base rental; the supplemental rental is a contingent rental that is excluded from minimum lease payments. The future sales for the lease term do not exist at lease inception, and future rentals would be limited to \$200 per month if the store were subsequently closed and no sales were made thereafter.

Example 7: Applying the Definition of Contingent Rentals—Rentals Contingent on Index or Rate**840-10-55-39**

This Example illustrates paragraph 840-10-25-4, which states that lease payments that depend on an existing index or rate, such as the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at lease inception. Assume that an equipment lease stipulates a monthly base rental of \$2,000 and a monthly supplemental rental of \$15 for each percentage point in the prime interest rate in effect at the beginning of each month. If the prime interest rate at lease inception is 10 percent, minimum lease payments would be based on a monthly rental of \$2,150 [$\$2,000 + (\$15 \times 10) = \$2,150$]. If the lease term is 48 months and no executory costs are included in the rentals, minimum lease payments would be \$103,200—that is, $\$2,150 \times 48$. If the lease is classified as a capital lease and the prime interest rate subsequently increases to 11 percent, the \$15 increase in the monthly rentals would be a contingent rental included in the determination of income as it accrues. If the prime interest rate subsequently decreases to 9 percent, the \$15 reduction in the monthly rentals would affect income as accruable. In the circumstance of either the increase or decrease, minimum lease payments would continue to be \$103,200.

Contingent rental arrangements may also contain embedded derivatives that must be evaluated pursuant to the “clearly and closely related” criteria of ASC 815-15. If the embedded derivative is not considered to be “clearly and closely related” to the host contract (i.e., the lease agreement), ASC 815-15 requires that the embedded derivative(s) be bifurcated and accounted for separately from the host contract. The following examples illustrate the application of the “clearly and closely related” analysis to contingent rental arrangements:

1. Inflation-indexed rentals (e.g., rentals vary based on increase in CPI) are considered to be clearly and closely related and would not be separated from the host contract unless a significant leverage factor is involved (e.g., rent payments escalate at twice the rate of an increase in CPI).

2. Contingent rentals based on sales volume of the lessee would not result in separation of the contingent-rental-related embedded derivative from the host contract. ASC 815-10-15-59 provides an exception from the application of ASC 815 to non-exchange-traded contracts with an underlying that is a specified volume of sales by one of the parties to the contract.
3. Contingent rentals based on a variable interest rate are generally considered to be clearly and closely related. Consequently, lease contracts that include contingent rentals based on changes in, for example, the prime rate or the LIBOR rate would not typically result in a separation of the contingent-rental-related embedded derivative from the host contract, unless the rental formula permits a significant leverage factor that more than doubles the effect of the rate.

See Section 2.9.1.5 for a discussion of whether certain non-traditional lease payments are minimum lease payments, contingent rentals or derivatives and Section 2.13.4 for a discussion of embedded foreign currency derivatives in operating leases. Our Accounting for derivative instruments and hedging activities FRD provides additional information and guidance about subsequent accounting for embedded derivatives in lease arrangements that are accounted for separately pursuant to ASC 815-15.

2.13.1

Tax indemnifications in lease agreements

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-10

Some leases contain indemnification clauses that indemnify lessors, on an after-tax basis, for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Although the indemnification payments may appear to meet the definition of contingent rentals, such payments are not of the nature normally expected to arise under contingent rent provisions.

840-10-25-11

Due to the close association of the indemnification payments to specific aspects of the tax law, any payments shall be accounted for in a manner that recognizes the tax law association. The original lease classification shall not be changed.

840-10-25-34

Paragraph 460-10-15-4(c) states that, except as provided in paragraph 460-10-15-7, the provisions of Subtopic 460-10 apply to indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party. Paragraph 460-10-55-23A provides related implementation guidance for a tax indemnification provided to a lessor.

840-10-25-53

Indemnification payments related to tax effects other than the investment tax credit shall be reflected by the lessor in income consistent with the classification of the lease. That is, the payments shall be accounted for as an adjustment of the lessor's investment if the lease is a capital lease or recognized ratably over the lease term if an operating lease.

Guarantees – Overall

Implementation Guidance and Illustrations

460-10-55-23A

This implementation guidance addresses the application of this Subtopic to the recognition and initial measurement of a tax indemnification provided by a lessee to a lessor. Paragraph 460-10-25-4 requires that the lessee (guarantor) account for a tax indemnification provided to the lessor by recognizing a liability at lease inception (which is also the inception of the indemnification clause). Section 460-10-30 requires that the measurement objective of that initial recognition be the fair value of the lessee's obligation under the indemnification agreement.

Indemnities for changes in tax laws

Some leases contain indemnification clauses that indemnify lessors, on an after-tax basis, for certain tax benefits a lessor may lose because of a change in tax law. Although the indemnification payments may appear to meet the definition of contingent rentals, such payments are not of the nature normally expected to arise under contingent rent provisions. Further, due to the close association of the payments to specific aspects of the tax law, the payments should be accounted for in a manner that recognizes the tax law association. The original lease classification should not be changed.

Indemnification payments received by lessors should be reflected in income consistent with the classification of the lease. That is, the payments should be accounted for as an adjustment to the lessor's investment if the lease is a direct financing or sales-type lease or recognized ratably over the lease term if an operating lease. The lease classification is not affected by indemnification clauses or indemnification payments received by the lessor.

A lessee's indemnification of the lessor for any adverse tax consequences that may arise from a change in the tax laws is generally subject to the provisions for guarantees under ASC 460. These types of indemnifications are not considered to be guarantees of the lessee's own future performance because only a legislative body can change the tax laws, and the lessee therefore has no control over whether payments will be required under that indemnification. In addition, while ASC 460-10-15-7(c) provides a scope exception for contracts that have the characteristics of a guarantee or indemnification, but are accounted for as contingent rent, because ASC 840-10-25-10 indicates that indemnification payments should not be accounted for as contingent rent, the scope exception does not apply. Therefore, to the extent a general indemnity requires additional payments to the lessor (or taxing authority) due to adverse changes in the tax law, regulations or ruling, the indemnification would generally be subject to ASC 460.

Illustration 2-13: Accounting for indemnity for changes in tax laws

Assume a lessor is a foreign entity that is not subject to tax withholding requirements and the lessor requires the lessee to indemnify the lessor for any future change in the tax law which would require the lessee to withhold income taxes from payments to the lessor. This may occur if the lessor's taxing authority enters into or modifies its tax treaty with the U.S. The effect of this indemnification would be to increase the lessee's payments for the leased property for the required withholding tax (which would be remitted directly to the IRS).

This arrangement meets the criteria of ASC 460-10-15-4(c) and therefore the indemnity is subject to the recognition and measurement provisions of ASC 460. Therefore, the lessee should record a liability for the guarantee based on its fair value, and the related expense should be amortized over the term of the lease.

As noted above, tax indemnities do not affect the original lease classification. That is, the fair value of the guarantee and the related expense should not be included in the 90% lease classification test per ASC 840-10-25-1(d) (see Section 3.2).

Note that the guidance in ASC 460 was codified primarily from FIN 45, which is effective for guarantees entered into or modified after 31 December 2002. For leases entered into prior to the effective date of FIN 45 that contain an indemnification clause for changes in tax laws, the lessee should follow the accounting guidance in EITF 86-33 unless the lease is modified. Under EITF 86-33, the lessee should account for any payments required as a result of the indemnification consistent with the accounting for non-level rents (see Section 4.3). Therefore, the lessee with an operating lease would account for the indemnification payments as additional expense ratably over the remaining lease term (the term remaining once it has been determined that a probable liability has been incurred – generally when the tax law changes) irrespective of when the payments are made. Lessees with capital leases should adjust the basis of the leased asset. Under EITF 86-33, the original lease classification should not be changed as a result of any indemnification payments made as a result of changes in the tax law.

General indemnity for increase in taxes

Many leases include a general indemnification that the lessee will directly pay (or reimburse the lessor) either the entire amount due or a pro-rata share of any increases in all sales, use or property taxes. As noted at Section 2.9.1.2, the payment of taxes by a lessee are considered executory costs that should be excluded from all the calculations required under ASC 840 (e.g., present value of lease payments for purposes of determining whether the lease is a capital lease). These payments, if any, should be expensed ratably over the lease term (see Section 2.6). These types of arrangements are generally not viewed as indemnifications under ASC 460.

Indemnities for adverse tax consequences that result from actions of the lessee

Many leases require the lessee to indemnify the lessor for any adverse tax consequences that may arise from acts, omissions and misrepresentations of the lessee. These types of indemnifications are generally related to the anticipated use of the leased property and level of taxation (or deductibility) related to that intended use. In the event that payments are required under this type of indemnity, lessees with operating leases should generally account for the payments as additional expense ratably over the lease term (see Section 2.6), regardless of when the payments are made. If the lease is a capital lease, then the lessee should adjust the basis of the leased asset. The additional expense would not be included in the minimum lease payments when analyzing the lease under ASC 840-10-25-1(d) (see Section 3.2).

Illustration 2-14: Accounting for indemnities for adverse tax consequences that result from actions of the lessee

Many real property tax rates are based on the use of the property (that is, a farm operation has lower tax rates than a manufacturing facility which is also less than a commercial office building). If the actual use of the property is other than the anticipated use at inception of the lease and results in a change in classification for real property tax rates, the lessor could experience significant adverse tax consequences. Assume Company A leases real property and is required to indemnify the lessor for any adverse tax consequences from changes in the use of the real property.

In this example, the Company A would account for additional payments that become payable as a result of the indemnity, if any, as additional expense ratably over the term of the lease if the lease is an operating lease. In the event that the lease is a capital lease, then Company A would adjust the basis of the leased asset. As noted above, any additional payments would not affect the determination of whether the lease is a capital or operating lease (ASC 840-10-25-1(d)).

In addition, because these indemnifications are generally within the control of the lessee (guarantor), they are viewed as guarantees of the guarantor's own future performance and thus excluded from the scope of ASC 460². In the example above, Company A has the ability to control the use of the real property and, therefore, the indemnification contained in the lease agreement is considered a guarantee of Company A's own future performance. Accordingly, the indemnification is excluded from the scope of ASC 460 in its entirety.

2.13.2 Lessee accounting for contingent rent

Some rental agreements provide for minimum rental payments plus contingent rents based on the lessee's operations. Often the specified targets are not achieved until the later months of either the lessor's or lessee's fiscal year. This may occur despite the fact that achievement of the targets is considered probable at some earlier point in the year. A lessee should recognize contingent rental expense (in annual periods as well as in interim periods) prior to the achievement of the specified target that triggers the contingent rental expense, provided that achievement of that target is considered probable (ASC 840-10-25-35 – see Section 2.13). Previously recognized rental expense should be reversed into income at such time that it is probable that the specified target will not be met (ASC 840-10-40-1 – see Section 2.13).

Illustration 2-15: Lessee accounting for contingent rent

A rental agreement requires an additional payment of \$1,000 if machine hours exceed 10,000 hours. The \$1,000 annual payment should be accrued throughout the year, as long as annual machine hours in excess of 10,000 hours are considered probable.

2.13.3 Lessor accounting for contingent rent

ASC 840 does not provide explicit guidance on how lessors should account for contingent rent. However, SAB Topic 13 provides that contingent rental income "accrues" (i.e., it should be recognized as revenue) when the changes in the factor(s) on which the contingent lease payments are based actually occur. This applies to both interim and annual periods. For example, if a lessor receives contingent rent if the lessee's sales exceed \$2,000,000 during the year, the lessor cannot recognize contingent rent until sales exceed this amount, regardless of probability. Consequently, it would be inappropriate to anticipate changes in the factors on which contingent rental income in operating leases is based and recognize rental income prior to the occurrence of the change in factors on which contingent rents are based. We believe that the guidance in SAB Topic 13 establishes preferable accounting for non-public lessors (in the event non-public lessors do not follow the guidance in SAB Topic 13 they would have to adopt the guidance in SAB Topic 13 retroactively if they decide to go public).

2.13.4 Embedded foreign currency derivatives in operating leases

In addition to the contingent rental and indexation features described in Section 2.13, certain operating lease arrangements contain foreign currency embedded derivatives that also need to be evaluated to determine whether separate accounting may be warranted for the embedded derivative(s) pursuant to the provisions of ASC 815-15. For example, if operating lease payments are denominated in a currency other than the currency of the primary economic environment in which any substantial party to the lease contract operates (i.e., in most lease arrangements, the functional or the local currency of the lessee or the lessor), the lease would be considered to include an embedded foreign currency swap arrangement that should be

² ASC 460-10-15-7(i) notes that the scope of ASC 460 does not encompass indemnifications or guarantees of an entity's own future performance (for example, a guarantee that the guarantor will not take a certain future action).

separated from the host contract (i.e., lease) and considered a derivative instrument under ASC 815 (provided that a separate instrument with the same terms would meet the definition of a derivative instrument). In evaluating whether foreign currency denominated payments are considered clearly and closely related to the terms of the lease, it is sufficient if lease payments are denominated in the functional currency of at least one substantial party to the transaction. ASC 815-15-15-11 further provides that the determination of the lessor's primary economic environment may be based on available information and reasonable assumptions, such that representations from the lessor are not necessarily required.

ASC 815-15-15-10 provides that the bifurcation requirements do not apply (i.e., does not require separate accounting for an embedded foreign currency derivative) if the lease payments are denominated in any of the following currencies:

1. The functional currency of any substantial party to the lease
2. The local currency of any substantial party to the lease
3. The currency used by a substantial party to the lease as if it were the functional currency because the primary economic environment in which that party operates is highly inflationary
4. The currency in which the price of the leased asset is routinely stated in international commerce (e.g., if it is current international practice for commercial jet leases to be denominated in U.S. Dollars).

In providing the fourth exception the FASB recognized that it would be appropriate to consider the currency in which contracts for a given asset are routinely denominated internationally to be clearly and closely related to those contracts, regardless of the functional currency of the parties to that contract. The application of the phrase "routinely denominated in international commerce" should be based on how similar transactions are routinely structured around the world, not just in one local area. Therefore, if similar leases for a certain asset are routinely denominated in international commerce in various different currencies, the exception provided by ASC 815-15-15-10 does not apply to any of those similar transactions. (ASC 815-15-15-14)

For purposes of evaluating whether a lease contains an embedded foreign currency derivative, a guarantor is not a substantial party to a two-party lease, even when it is a related party of the lessee or the lessor (e.g., a parent company guarantee provided to its subsidiary, even if the parent company consolidates the subsidiary). The substantial parties to a lease contract are the lessor and the lessee. (ASC 815-15-55-84 through 55-86)

The evaluation of whether a lease qualifies for the exception is performed only at the inception of the contract.

It should be noted that capital leases denominated in a nonfunctional currency are governed by the provisions of ASC 830, *Foreign Currency Matters*, and would not be subject to the embedded derivatives provisions of ASC 815-15.

For more guidance about subsequent accounting for embedded derivatives in lease arrangements that are accounted for separately pursuant to ASC 815-15, see our Accounting for derivative instruments and hedging activities FRD.

2.14

Penalty**Excerpt from Accounting Standards Codification****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 do any of the following:

- a. Disburse cash
- b. Incur or assume a liability
- c. Perform services
- d. 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 whether an economic detriment may be incurred include, but are not limited to, all of the following:
 1. The uniqueness of purpose or location of the property
 2. The availability of a comparable replacement property
 3. The relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers
 4. The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property
 5. Adverse tax consequences
 6. 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.

A penalty is any requirement for a lessee to forgo an economic benefit or suffer an economic detriment. A penalty may affect the assessment of lease term (see Section 2.6), purchase options and minimum lease payments. As described in Section 2.6.1, a penalty may be sufficiently large enough to make the exercise of a renewal option reasonably assured at the inception of a lease (see Section 2.2) resulting in an increased lease term. Similarly, a penalty can create a bargain purchase option (see further discussion in Section 2.4.2). In instances where a penalty is not sufficiently large enough to result in a renewal or purchase option being reasonably assured of exercise at the inception of a lease, the penalty may need to be included in minimum lease payments. For example, if a lease includes an insignificant penalty for failure to renew and the lessee determines that renewal of the lease is not reasonably assured at inception of the lease, the penalty should be included in the minimum lease payments to the extent that the penalty represents an actual cash payment to the lessor or a third party.

It is important to note that a penalty is not solely a payment to a lessor but may be a payment to a third party or a loss of future earnings by the lessee. For example, if a lessee leases equipment that is utilized to generate operating income and alternative equipment is not available, the loss of the ability to generate operating income might represent a penalty associated with terminating the lease.

3 Lease classification

3.1 Classification of leases (other than real estate)

Excerpt from Accounting Standards Codification

Leases – Overall

Objectives

840-10-10-1

The objective of the lease classification criteria in this Subtopic derives from the concept 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.

The objective of lease classification and the criteria used for lease classification in accordance with ASC 840 derive from the concept that a lease that transfers substantially all of the benefits and risk 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 leases that do not transfer substantially all (as determined in accordance with ASC 840-10-25) such benefits and risks are treated as operating leases. From the standpoint of the lessee, leases are classified as capital leases or operating leases. From the standpoint of the lessor, leases are classified as sales-type leases, direct finance leases, leveraged leases or operating leases. The criteria used for lease classification is discussed below.

See Sections 4 and 5 for further discussion of additional classification considerations specific to lessees and lessors and Section 6 for further discussion of additional classification considerations related to leases of real estate.

3.2 Criteria for classification of leases

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-1

A lessee and a lessor shall consider whether a lease meets any of the following four criteria as part of classifying the lease at its inception under the guidance in the Lessees SubSection of this Section (for the lessee) and the Lessors SubSection of this Section (for the lessor):

- a. **Transfer of ownership.** The lease transfers ownership of the property to the lessee by the end of the lease term. 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.
- b. **Bargain purchase option.** The lease contains a bargain purchase option.
- c. **Lease term.** The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

- d. Minimum lease payments. The present value at the beginning of the lease term of the minimum lease payments, 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 to the lessor at lease inception over any related investment tax credit retained by the lessor and expected to be realized by the lessor. 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.

840-10-25-29

If at its inception a lease meets any of the four lease classification criteria in paragraph 840-10-25-1, the lease shall be classified by the lessee as a capital lease.

840-10-25-30

If none of the four criteria in paragraph 840-10-25-1 are met, the lease shall be classified by the lessee as an operating lease.

840-10-25-31

A lessee shall compute the present value of the minimum lease payments using the lessee's incremental borrowing rate unless both of the following conditions are met, in which circumstance the lessee shall use the implicit rate:

- a. It is practicable for the lessee to learn the implicit rate computed by the lessor.
- b. The implicit rate computed by the lessor is less than the lessee's incremental borrowing rate.

840-10-25-32

The lessee in a sublease shall classify the lease in accordance with the four lease classification criteria in paragraph 840-10-25-1 and account for it accordingly.

840-10-25-33

From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as nonleveraged leases.

Lessees should classify all leases at the inception date (see Section 2.2) as either a capital lease or an operating lease. A lease is a capital lease if it meets any one of the following criteria; otherwise, it is an operating lease:

1. Ownership is transferred to the lessee by the end of the lease term (see Section 2.6).
2. The lease contains a bargain purchase option (see Section 2.4).
3. The lease term (see Section 2.6) is at least 75% of the property's estimated remaining economic life (see Section 2.7). (This criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term.)
4. The present value of the minimum lease payments (see Section 2.9) at the beginning of the lease term (see Section 2.6) is 90% or more of the fair value of the leased property to the lessor at the inception date, less any related investment tax credit (the Tax Reform Act of 1986 repealed the investment tax credit provision of the Internal Revenue Code) retained by the lessor and expected to be realized by him. (This criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term.)

These criteria generally require lessees to capitalize leases for which the lessor is assured investment recovery and a reasonable return.

See Section 3.3 for additional classification considerations for lessors and Section 6 for additional classification considerations for leases of real estate.

3.2.1 Transfer of ownership

A lease is classified as a capital lease if the lease transfers ownership of the property to the lessee by the end of the lease term (see Section 2.6). 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 no additional consideration or the payment of nominal consideration (the minimum required by statutory regulation to transfer title). A provision in a lease agreement that ownership of the leased property does not transfer if the lessee elects not to pay a specified fee (nominal or otherwise) to complete the transfer is a purchase option – not an automatic transfer of ownership (ASC 840-10-25-50 – see Section 6.4.2).

3.2.2 Bargain purchase option

A lease is classified as a capital lease if it contains a bargain purchase option. A bargain purchase option is an option that allows the lessee to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property such that exercise of the option appears, at the inception of the lease, to be reasonably assured. A purchase option can be a bargain based on the price of the option (e.g., a fixed price purchase option priced significantly below the expected fair value of the leased property) or due to penalties – see Section 2.14 – (e.g., a fair value purchase option for specialized equipment critical to the operations of the lessee that cannot be readily replaced). See Section 2.4 for further discussion regarding bargain purchase options.

3.2.3 Lease term in excess of 75% of useful life

A lease is a capital lease if the lease term (see Section 2.6) is at least 75% of the leased property's estimated remaining economic life (see Section 2.7). This criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term (i.e., the lease term commences in the last 25% of the leased asset's estimated economic life).

3.2.4 Present value of lease payments versus fair value of leased asset

A lessee is required to capitalize a lease if the present value of the minimum lease payments at the beginning of the lease term is 90% or more of the fair value of the leased property to the lessor at the inception date, less any related investment tax credit retained by the lessor and expected to be realized by it (the Tax Reform Act of 1986 repealed the investment tax credit provision of the Internal Revenue Code). This criterion is not applicable if 75% or more of the leased asset's estimated economic life has elapsed as of the beginning of the lease term. See Section 2.3 for guidance on determining fair value, Section 2.9 for guidance on determining the minimum lease payments, Section 2.6 for a discussion of the lease term and Section 2.2 for guidance on determining the lease inception date.

3.2.4.1 Lessee discount rate

The discount rate used by the lessee in determining the present value of the minimum lease payments is the lower of the lessee's incremental borrowing rate or the implicit rate in the lease, if it is practicable for the lessee to learn the implicit rate computed by the lessor. Generally, the lessee will not know the implicit rate computed by the lessor. Thus, in many cases, a different rate will be used by the lessee and lessor for purposes of determining lease classification. In those situations where it is not practical for the lessee to learn the implicit rate in the lease, the lessee generally should use the rate, secured or unsecured, that is consistent with the financing that would have been used had the asset been purchased rather than leased. That rate is referred to as the incremental borrowing rate and is further described in Section 2.11. A lessee is not required to estimate the implicit rate.

The implicit interest rate in a lease is used by the lessor to compute present values. It is the rate that, when applied to (1) the minimum lease payments (see Section 2.9) and (2) the lessor's unguaranteed residual value (see Section 2.8), results in an aggregate present value equal to the fair value of the property at the inception date. The interest rate implicit in the lease is further described in Section 2.10.

The "practicable to learn" limitation does not require the communication of the implicit rate by the lessor to the lessee, either in the lease agreement or otherwise, although some hold the view that the lessee should request the implicit rate from the lessor (they agree however, that the lessee cannot ordinarily compel the lessor to supply such information). The implicit rate can, however, be determined if the lessee knows the asset's cost to the lessor, the amounts included in the minimum lease payments for executory costs (and any related profit) and the unguaranteed residual value determined by the lessor that accrues to the lessor. In many cases, that information will not be known by the lessee. In those cases, the lessee will use its incremental borrowing rate. Estimation of the rate implicit in the lease also requires an assessment of the lessor's ability to realize any retained investment tax credit; however, the usual assumption is that any investment tax credit will be realized if it is retained. In some cases, for example in synthetic lease structures, where the lessee is the beneficiary of any and all proceeds attributable to the leased property above a specified dollar amount (i.e., residual value in excess of the lessee's guarantee), the lessee generally will be able to determine the implicit rate computed by the lessor, assuming that the lessor's cost and fair value are equal.

3.2.4.2 Beginning of lease term versus inception of lease

The determination of the fair value of the leased asset is made at the inception date of a lease (see Section 2.2), whereas the net present value of the lease obligation is measured at the beginning of the lease term (see Section 2.6). This distinction is important as it directly impacts the calculations under the 90% test. For example, assume that on 1 January 20X1, Company A executes a long-term lease agreement to lease an existing cargo vessel beginning on 30 June 20X2. To perform the 90% recovery test under ASC 840-10-25-1(d) (see Section 3.2), Company A would compare the present value of minimum lease payments under the lease as of 30 June 20X2 to the fair value of the cargo vessel as of 1 January 20X1. Increases or decreases in the fair value of the cargo vessel from 1 January 20X1 to 30 June 20X2 would not be considered in the test.

3.2.4.3 Residual value guarantees included in minimum lease payments

As discussed in detail in Section 2.9, both lessees and lessors include residual value guarantees provided by the lessee (or a third party related to the lessee) in minimum lease payments for purposes of performing the lease classification test in ASC 840-10-25-1(d) (see Section 3.2). Guarantees of residual value are included in minimum lease payments without regard to either the likelihood of the payment of such guarantee or the leased asset's estimated fair value at the time the payment under the guarantee is determined. In addition, lessors include the amount of any guarantee of the residual value or rental payments beyond the lease term (see Section 2.6) by a third party unrelated to the lessee or lessor in minimum lease payments for determining the classification of a lease; whereas lessees do not include such amounts. As a result, the purchase of a third party guarantee may result in a lessor classifying a lease as a sales-type or direct finance lease and a lessee classifying the same lease as an operating lease.

See Section 2.9.2 for further discussion of guarantees by lessees of residual value at the end of the lease term and Section 2.9.3 for further discussion of third party guarantees of lease payments or residual value.

3.3

Additional lessor classification criteria**Excerpt from Accounting Standards Codification****Leases – Overall***Recognition***840-10-25-41**

In applying the minimum-lease-payments criterion in paragraph 840-10-25-1(d), a lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease.

840-10-25-42

A lessor shall consider all four lease classification criteria in paragraph 840-10-25-1 and both of the following incremental criteria:

- 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. 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 paragraph 840-30-30-6(a)) shall not by itself constitute an important uncertainty as referred to herein. If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at lease inception, the classification criterion in this paragraph shall be applied by the lessor at the date that construction of the property is completed or the property is acquired by the lessor.

840-10-25-43

If the lease at inception meets any of the four lease classification criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph, it shall be classified by the lessor as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as follows:

- a. Sales-type lease. A lease is a sales-type lease if it gives rise to manufacturer's or dealer's profit (or loss) to the lessor (that is, the fair value of the leased property at lease inception is greater or less than its cost or carrying amount, if different) and meets either of the following conditions:
 1. It involves real estate and meets the criterion in paragraph 840-10-25-1(a), (in which circumstance, neither of the criteria in paragraph 840-10-25-42 applies).
 2. It does not involve real estate and meets any of the criteria in paragraph 840-10-25-1 and both criteria in paragraph 840-10-25-42.

For implementation guidance on the interaction of lease classification and lessor activities, see paragraph 840-10-55-41.
- b. Direct-financing lease. A lease is a direct financing lease if it meets all of the following conditions:
 1. It meets any of the criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph.

2. It does not give rise to manufacturer's or dealer's profit (or loss) to the lessor.
 3. It does not meet the criteria for a leveraged lease in (c).
- c. Leveraged lease. Leases that meet the criteria of sales-type leases set forth in (a) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph 840-30-25-6. A lease is a leveraged lease if it has all of the following characteristics:
1. It meets the criteria in (b)(1) and (b)(2) for a direct financing lease.
 2. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
 3. 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.
 4. The lessor's net investment (see paragraph 840-30-25-8) 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.
- d. Operating lease. A lease is an operating lease if it does not meet any of the four criteria in paragraph 840-10-25-1 or both of the criteria in the preceding paragraph. This includes a lease that involves real estate and give rise to manufacturer's or dealer's profit (or loss) to the lessor but do not meet the criterion in 840-10-25-1(a).

840-10-25-44

From the standpoint of the lessor, a lease involving real estate shall be classified by the lessor as a sales-type lease only if it meets the transfer-of-ownership criterion in paragraph 840-10-25-1(a).

840-10-25-45

In a direct-financing lease, the cost or carrying amount, if different, and fair value of the leased property are the same at lease inception.

Other Presentation Matters

840-10-45-4

Leases of a manufacturing entity's equipment sold to a leasing subsidiary that are accounted for as direct financing leases on the subsidiary's financial statements normally would be sales-type capital leases in the consolidated financial statements.

Implementation Guidance and Illustrations

840-10-55-41

This guidance discusses the relationship between lease classification criteria and certain lessor activities. 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 840-10-25-1 and 840-10-25-42, but will most often be direct financing leases, described in paragraph 840-10-25-43(b). However, a lessor need not be a dealer to realize dealer's profit (or loss) on a transaction. For example, if a lessor, not a dealer, leases an asset that at lease inception 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 lease, other than a lease involving real estate, meeting any one of the four criteria discussed in Section 3.2 at the inception date of the lease is classified as either a sales-type, direct financing or leveraged lease by the lessor, provided it also meets the two additional criteria discussed above.

Leases that do not meet both of the additional lessor criteria are classified as operating leases. A lease involving real estate must meet additional requirements to be treated as a direct finance or sales-type lease (See further discussion in Section 6).

3.3.1 Collectibility

A lease that would otherwise meet the tests to be classified either as a sales-type lease, direct finance lease or a leveraged lease but that does not meet the “collectibility of the minimum lease payments is reasonably predictable” criterion is classified as an operating lease by the lessor. As with any other receivable, estimates must be made about the collectibility of amounts receivable from leases based on either experience with groups of similar leases or receivables or the circumstances surrounding a particular lease. ASC 840-10-25-42(a) (see Section 3.3) provides “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.” As a result, collectibility determinations must be made on a lease-by-lease basis. In practice, the use of credit scoring to group lease receivables and then establishing collectibility on a group basis would be permissible for a homogenous portfolio whereas simply using a historical 10% default rate would not be permissible.

3.3.1.1 Accruing bad debt expense at inception of a lease

Prior to the issuance of Statement 91, a variety of methods were used by lessors to account for bad debt expenses related to lease receivables, including recording the expense as an offset to unearned income as opposed to expense. The recording of bad debt expense as a charge against unearned income essentially recognizes the charge over the lease term and the reserve that was recorded results in a corresponding increase in the net lease receivable. In the basis for conclusions for Statement 91, the FASB concluded that the practice of accelerating the recognition of lease finance revenues to offset initial direct costs or other costs of direct financing leases should no longer be acceptable (paragraph 44 of Statement 91). Similarly, the EITF noted in EITF Topic D-8 that a lessor should not accrue bad debts at the inception of a lease as a charge against unearned finance lease income, but rather that recognition of bad debts should be based on the guidance provided in ASC 450, *Contingencies*.

3.3.2 Important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease

Leases that do not meet the “no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease” criterion are classified as operating leases by the lessor. ASC 840-10-25-42(b) (see Section 3.3) notes that “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.” An ordinary product warranty would not represent an important uncertainty. However, a lease bundled within a multiple-element service-type contract may include a guarantee of asset performance for the entire service contract period, which is often longer than the typical product warranty.

3.4 Revision and termination of leases

Excerpt from Accounting Standards Codification

Leases – Overall

Subsequent Measurement

840-10-35-4

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 lease classification criteria in paragraphs 840-10-25-1 and 840-10-25-42 had the changed terms been in effect at lease inception, the revised agreement shall be considered as a new agreement over its term, and the lease classification criteria in paragraphs 840-10-25-1 and 840-10-25-42 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs 840-30-35-8 and 840-30-35-23, any action that extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the guidance in Section 840-10-25. 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) shall not give rise to a new classification of a lease for accounting purposes.

An existing lease is considered a new agreement when it is renewed or extended beyond the original lease term (see Section 2.6). The exercise of a renewal option included as part of the original lease term (e.g., an option period for which exercise was reasonably assured because of a termination penalty) is not a renewal or extension of a lease. See Sections 4.2.1 and 4.3.7 for lessee accounting and Section 5.1.4.1 and 5.3.4 for lessor accounting when a lease is renewed or extended.

A new agreement also results when lease provisions (e.g., amount of rental payments) are changed in a manner that would have resulted in the lease being classified differently had the new terms been in effect at the original inception date (see Section 2.2). Changes in estimates (e.g., economic life or residual value) do not change the classification of a lease.

3.4.1 Changes in lease agreements other than extending the lease term

A change in a lease agreement other than to extend the lease term requires a test to be performed to determine if a new lease has been created and a second test to determine the accounting for that new lease. The tests are as follows:

1. The first test is performed to determine whether the classification of the lease, at its inception, would have been different had the new terms been in force at the inception of the lease. For example, if the monthly rental under a 60-month lease is changed from \$1,000 a month to \$1,200 a month effective for the last 36 months, the lease is to be tested against the lease classification criteria of ASC 840-10-25 (as of its inception date) as if originally it required 24 monthly payments of \$1,000 and 36 monthly payments of \$1,200. All other factors (interest rate, fair value and estimated residual value) used for purposes of making this test would be the same as those used when the lease was classified initially. If, as a result of this first test, it is determined that the new lease terms would have resulted in a different classification of the lease as of its inception date, then the revised lease is considered to be a new lease. If the test indicates that a new lease would result, the second test described below must be performed. If this test indicates that a new lease would not have resulted (because the lease classification would not have changed), the recorded asset and obligation balances should be adjusted by the difference between the outstanding obligation balance and the present value of the future minimum lease payments using the updated lease agreement terms.

2. The second test is made as of the date of the change in lease terms, assuming that the first test would result in a different lease classification, and uses the revised terms of the lease over its remaining life and other factors (interest rate, fair value, estimated residual value, etc.) as they exist at the date of the change. The results of the second test determine the required accounting for the new lease. See Sections 4.2.2 and 4.3.8 for lessee accounting and Sections 5.1.4.2, 5.2.2, and 5.3.5 for lessor accounting when it is determined that a change in lease terms results in a new lease.

4 Lessee accounting

This Section deals with lessee accounting, while the next section, Section 5, deals with lessor accounting. Section 3 describes the criteria used to classify leases and Section 6 describes additional classification criteria for leases of real estate. Lessees must classify each of their leases as either capital or operating.

4.1 Accounting for capital leases

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Recognition

840-30-25-1

The lessee shall recognize a capital lease as an asset and an obligation.

840-30-25-2

Contingent rentals shall be included by a lessee in the determination of income as accruable.

Initial Measurement

840-30-30-1

The lessee shall measure a capital lease asset and capital lease obligation initially 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) including any profit thereon.

840-30-30-2

If the portion of the minimum lease payments representing executory costs (including profit thereon) is not determinable from the provisions of the capital 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 the minimum-lease-payments criterion in paragraph 840-10-25-31.

840-30-30-3

If the present value of the minimum lease payments exceeds the fair value of the leased property at lease inception, the amount measured initially as the asset and obligation shall be the fair value. If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of the fair value of the leased property at lease inception for purposes of this paragraph.

Subsequent Measurement

840-30-35-1

Except as provided in the following paragraph and paragraph 840-30-35-3 with respect to leases involving land, the asset recorded by a lessee under a capital lease shall be amortized as follows:

- a. If the lease meets either the transfer-of-ownership criterion in paragraph 840-10-25-1(a) or the bargain-purchase-option criterion in paragraph 840-10-25-1(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 the transfer-of-ownership criterion in paragraph 840-10-25-1(a) or the bargain-purchase-option criterion in paragraph 840-10-25-1(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. For example, if the lessee guarantees a residual value at the end of the lease term and has no interest in any excess that might be realized, the expected value of the leased property to the lessee is the amount that can be realized from the lease property up to the amount of the guarantee.

840-30-35-5

For guidance on lessee accounting for impairment of a capital lease, see the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10.

840-30-35-6

During the lease term, each minimum lease payment shall be allocated by the lessee between a reduction of the obligation and interest expense to produce a constant periodic rate of interest on the remaining balance of the obligation (the interest method).

840-30-35-7

In capital leases containing a residual guarantee by the lessee or a penalty for failure to renew the lease at the end of the lease term, following the method of amortization in the preceding paragraph will result in a balance of the obligation at the end of the lease term that will equal the amount of the residual value guarantee or penalty at that date. A residual value guarantee or termination penalty that serves to extend the lease term is excluded from minimum lease payments and is thus distinguished from those residual value guarantees and termination penalties referred to in this paragraph.

Other Presentation Matters

Lessees

840-30-45-1

Assets recorded under capital leases and the accumulated amortization thereon shall be separately identified in the lessee's balance sheet or in footnotes thereto.

840-30-45-2

Obligations under capital leases shall be separately identified as such in the lessee's balance sheet and shall be subject to the same considerations as other obligations in classifying them with current and noncurrent liabilities in classified balance sheets.

840-30-45-3

An entity is not required to classify interest expense or amortization of leased assets as separate items in the income statement. However, unless the charge to income resulting from amortization of assets recorded under capital leases is included by the lessee 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.

4.1.1 Present value of minimum lease payments greater than fair value of leased property

If the lessee's calculation of the present value of minimum lease payments is greater than the fair value of the leased asset, the incremental borrowing rate (see Section 2.11) should be adjusted so that the present value of lease payments does not exceed the fair value of the leased asset. This adjustment will result in the recognition of higher interest expense. This adjustment is required because ASC 840-30-30-3 (see Section 4.1) precludes the recognition of a capital asset in an amount greater than fair value.

4.1.2 Amortization of assets under a capital lease

A capital lease asset should be amortized in a manner consistent with the lessee's normal depreciation policy, generally over the lease term (see Section 2.6). However, if ownership is transferred by the end of the lease, or there is a bargain purchase option, the asset should be amortized, normally on a straight-line basis, over the useful life that would be assigned if the asset were owned.

Periodic minimum lease payments on capital leases are allocated between a reduction of the obligation and interest expense to produce a constant periodic interest rate on the remaining balance of the obligation. This will result in a remaining balance of the obligation at the end of the lease term equal to the amount of any (1) bargain purchase option (see Section 2.4), (2) residual guarantee (see Section 2.9.2) or (3) termination penalty (see Section 2.14), provided the lease term does not include renewal periods reasonably assured because of the existence of a penalty. See Section 2.13.2 for discussion of lessee accounting for contingent rent.

See Section 4.1.4 for a comprehensive example.

4.1.3 Asset impairment – capital lease

Assets leased under a capital lease should be assessed for impairment, similar to other owned fixed assets, under the provisions of ASC 360-10. See our Impairment or disposal of long-lived assets FRD for further discussion on assessing an asset for impairment.

4.1.4 Comprehensive capital lease example

The following example illustrates many of the requirements for a lessee's accounting for a capital lease; however, it is unlikely all of these factors would be found in the same lease.

Illustration 4-1: Accounting for a capital lease

A company enters into a 5-year noncancelable lease, with four renewal options of one year each, for machinery having an estimated economic life of 10 years and a fair value to the lessor at the inception date of \$370,000. The implicit interest rate is unknown, and the company's incremental borrowing rate is 12%. The straight-line method is used by the company to depreciate owned assets. The lease contains the following provisions:

- ▶ Rental payments of \$5,300 per month, including \$300 for property taxes, payable at the beginning of the month
- ▶ A guarantee by the company of the lessor's 7-year bank loan obtained to finance construction of the machinery
- ▶ A termination penalty assuring renewal of the lease for a period of two years after the expiration of the loan guarantee
- ▶ An option allowing the lessor to extend the lease for one year beyond the last renewal option exercised by the company
- ▶ A guarantee by the company that the lessor will realize \$5,000 from selling the asset at the expiration of the lease

This lease is a capital lease because its term (10 years – see computation below) exceeds 75% of the machinery's estimated economic life. In addition, the present value (\$353,503) of the minimum lease payments exceeds 90% of the fair value of the machinery (\$333,000). See computations below.

Lease term:	
Noncancelable period	5 years
Additional period debt is guaranteed	2 years
Additional period for which termination penalty assures renewal	2 years
Period covered by lessor extension option	<u>1 year</u>
	<u>10 years</u>
Minimum lease payments:	
Monthly rental payments	\$ 5,300
Executory costs	<u>(300)</u>
	5,000
Lease term in months	X <u>120</u>
	600,000
Residual guarantee	<u>5,000</u>
	<u>\$ 605,000</u>
Present value of payments:	
Factor for present value of \$1 payable in 119 monthly payments at 1% (12% per year compounded monthly)	69.3975
Initial payment (no interest element)	<u>1.0000</u>
	70.3975
Monthly rental payments, net of executory costs	X \$ <u>5,000</u>
	\$ 351,988
Factor for present value of \$1 due in 10 years (12% per year compounded monthly)	0.3030
Residual guarantee	X \$ <u>5,000</u>
	<u>1,515</u>
	<u>\$ 353,503</u> ¹

¹ If the fair value of the machinery is less than the present value of the minimum lease payments, the asset and obligation are recorded at the fair value. This results in using an interest rate greater than the lessee's incremental borrowing rate in allocating the lease payments between principal and interest.

The following table summarizes the lease obligation amortization and the interest expense over the term of the lease:

Year	Annual net rental payments ²	Annual interest expense ³	Lease obligation at end of year
Initial present value	\$ -	\$ -	\$353,503
1	60,000	40,786	334,289
2	60,000	38,349	312,638
3	60,000	35,605	288,243
4	60,000	32,509	260,752
5	60,000	29,023	229,775
6	60,000	25,095	194,870
7	60,000	20,668	155,538
8	60,000	15,679	111,217
9	60,000	10,059	61,276
10	60,000	3,724	5,000 ⁴

² Annual gross rental payments of \$63,600 less \$3,600 included for property taxes.

³ Accumulated annual amounts resulting from applying an interest rate of 1% to the balance of the lease obligation at the beginning of each month. The lease obligation is increased by the amount of the prior month's interest and reduced by \$5,000, the amount of the net rental payment at the beginning of each month.

⁴ This amount represents the guaranteed residual value at the end of the lease term.

The journal entries to account for this lease during the first year are as follows:

To record capitalized lease:

Capitalized leases – machinery	\$ 353,503	
Obligations under capital leases:		
Current		\$ 19,214
Long-term		334,289

To record first year's rental payments:

Interest expense	\$ 40,786	
Obligations under capital leases – current	19,214	
Property taxes	3,600	
Cash		\$ 63,600

To record first year's amortization of capitalized lease asset⁵:

Amortization expense – capitalized leases – machinery	\$ 35,350	
Accumulated amortization – capitalized leases – machinery		\$ 35,350

To record current portion of lease obligation:

Obligations under capital leases – long-term	\$ 21,651	
Obligations under capital leases – current		\$ 21,651

⁵ The company assumes no amount will be realized from the sale of the machinery and that it will pay the \$5,000 residual value guarantee.

The following table shows the annual charges to operations for this capital lease as compared with the expense that would be recorded if it were classified as an operating lease:

Year	Capital lease				Operating lease ⁶	Pretax increase (decrease)
	Interest	Amortization	Taxes	Total		
1	\$ 40,786	\$ 35,350	\$ 3,600	\$ 79,736	\$ 64,100	\$(15,636)
2	38,349	35,350	3,600	77,299	64,100	(13,199)
3	35,605	35,350	3,600	74,555	64,100	(10,455)
4	32,509	35,350	3,600	71,459	64,100	(7,359)
5	29,023	35,350	3,600	67,973	64,100	(3,873)
6	25,095	35,350	3,600	64,045	64,100	55
7	20,668	35,350	3,600	59,618	64,100	4,482
8	15,679	35,350	3,600	54,629	64,100	9,471
9	10,059	35,350	3,600	49,009	64,100	15,091
10	3,724	35,353	3,600	42,677	64,100	21,423
	\$251,497	\$353,503	\$36,000	\$641,000	\$641,000	\$ -

⁶ Consists of 12 monthly lease payments (including executory costs) of \$5,300 and 1/10 of \$5,000, the amount of the guaranteed residual value.

4.2 Renewal or extension of a capital lease

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Subsequent Measurement

840-30-35-8

If 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 residual value guarantee or termination 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. Paragraphs 840-30-35-15 through 35-20 address a lessee's accounting for other lease modifications.

840-30-35-15

Paragraph 840-10-35-4 provides overall guidance on lease modifications. This incremental guidance for the lessee in a capital lease is organized as follows:

- a. Lease term renewals and extensions
- b. Other lease modifications.

Lease term renewals and extensions

840-30-35-16

Paragraph 840-30-35-8 addresses a renewal or extension of the lease term (including a new lease under which the lessee continues to use the same property) that renders a residual value guarantee or termination penalty inoperative.

840-30-35-17

Other renewals and extensions of the lease term (including a new lease under which the lessee continues to use the same property) shall be considered new agreements (in accordance with paragraph 840-10-35-4) that shall be accounted for by the lessee as follows:

- a. If the renewal or extension is classified by the lessee as a capital lease, it shall be accounted for by the lessee in accordance with the guidance in paragraph 840-30-35-19.
- b. If the renewal or extension is classified by the lessee as an operating lease, the existing lease shall continue to be accounted for by the lessee as a capital lease to the end of its original term, and the renewal or extension shall be accounted for by the lessee as any other operating lease in accordance with the guidance in Subtopic 840-20.

Other lease modifications

840-30-35-18

Paragraph 840-30-35-10 addresses a lessee's accounting for a change in the provisions of a capital 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.

840-30-35-19

Except in that circumstance, if the provisions of a capital lease are changed in a way that changes the amount of the remaining minimum lease payments, 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 (computed using the interest rate used to recognize the lease initially) and the present balance of the obligation if the change meets either of the following conditions:

- a. It does not give rise to a new agreement under the guidance in paragraph 840-10-35-4.
- b. It does give rise to a new agreement under the guidance in paragraph 840-10-35-4 but such agreement is also classified by the lessee as a capital lease.

840-30-35-20

Paragraph 840-40-15-6 requires that, except in the circumstances discussed in paragraph 840-30-35-10, if the change in the provisions of a capital lease gives rise to a new agreement classified as an operating lease, the transaction be accounted for by the lessee in accordance with the sale-leaseback requirements of Subtopic 840-40.

Leases – Capital Leases***Derecognition*****840-30-40-1**

A termination of a capital lease before the expiration of the lease term shall be accounted for by the lessee by removing the asset and obligation, with gain or loss recognized for the difference.

4.2.1 Renewal or extension of original capital lease term

An existing lease is considered a new agreement when it is renewed or extended beyond the original lease term (see Section 2.6) as long as the renewal or extension does not “render inoperative” a guarantee or penalty provision which was a part of the original lease (see Section 4.2.1.1). The following summarizes the accounting for the new lease:

1. Extension of a capital lease with a capital lease – When both the original lease and the new agreement are classified as capital leases, the recorded asset and obligation balances are adjusted at the date of the revision by the difference between the outstanding obligation balance and the present value of the future minimum lease payments. The present value of the future minimum lease payments under the revised or new agreement should be computed using the rate of interest used to record the lease initially.
2. Extension of a capital lease with an operating lease – If the new agreement arises from a renewal or extension, the original lease continues to be accounted for as a capital lease to the end of its lease term. Thereafter, the new agreement is accounted for as an operating lease.

Illustration 4-2: Accounting for the extension of a capital lease with an operating lease

An asset with an estimated economic life of 12 years is leased for 10 years and classified as a capital lease. After 9 years have elapsed, the lease term is extended so that the entire term of the lease, as revised, is 12 years. The capital lease continues to be accounted for as such until the end of the tenth year after which the agreement is classified as an operating lease (the beginning of the extension period falls within the last 25% of the asset’s total estimated economic life; therefore, if the extension does not transfer title or contain a bargain purchase option the lease is automatically an operating lease).

4.2.1.1 **Renewal option or other action renders a capital lease guarantee or penalty provision inoperative**

As noted in Section 4.2.1, when the original lease is a capital lease and the exercise of a renewal option or other action extending the lease term has the effect of “rendering inoperative” a guarantee or penalty provision which was a part of the original lease, the extension or renewal does not create a new lease agreement. In this situation, the accounting procedures dictate that the recorded asset and obligation balances under the capital lease should be adjusted by the difference between the outstanding obligation balance and the present value of the future minimum lease payments under the amended lease.

The following are examples of actions that do not create a new lease agreement:

- ▶ A lessee exercises a renewal option (which was not part of the lease term as defined), thereby avoiding a penalty that could have been imposed at the end of the original lease term.
- ▶ A lessee agrees to lease an asset for five years beyond the present lease expiration date, in exchange for which the lessor agrees to relieve the lessee of a guarantee of the residual value.

4.2.2 **Change in capital lease (other than extending the lease term) that results in a new lease**

A change in a capital lease other than to extend the lease term that results in a new lease (see Section 3.4.1) should be accounted for as follows:

1. When both the original lease and the new agreement are classified as capital leases, the recorded asset and obligation balances are adjusted by the difference between the outstanding obligation balance and the present value of the future minimum lease payments. The present value of the future minimum lease payments under the revised or new agreement should be computed using the rate of interest used to record the lease initially.
2. When a new agreement is classified as an operating lease and replaces a capital lease, the transaction is accounted for as a sale-leaseback pursuant to the requirements of ASC 840-40 (see Section 8 for leases of non-real estate assets or Section 9 for leases of real estate including integral equipment).

4.2.3 **Extinguishment of a capital lease obligation**

ASC 405-20-40-1 provides guidance for determining when a liability (including a capital lease obligation) has been extinguished and therefore can be removed from the obligor’s (lessee’s) balance sheet. A capital lease obligation is considered extinguished (and a gain or loss is recognized) if either of the following two conditions are met:

1. The lessee pays the lessor and is relieved of its obligation for the liability. Paying the lessor includes delivery of cash, other financial assets, goods or services, or the reacquisition by the lessee of its outstanding debt securities.
2. The lessee is legally released from being the primary obligor under the liability, either judicially or by the lessor.

Some sale and assumption agreements may have other components warranting accounting recognition. For example, a lessor might release a lessee as primary obligor on the condition that a third party assumes the obligation and that the original lessee becomes secondarily liable. While the release extinguishes the original lessee's liability as the primary obligor, the lessee becomes a guarantor, regardless of whether consideration was paid for the guarantee. As a guarantor, the original lessee will recognize a guarantee obligation at fair value (under ASC 460, *Guarantees*) in the same manner as would a guarantor that had never been primarily liable to that lessor. Under ASC 460, recognition of the guarantee would take into consideration the likelihood that the new primary obligor will fulfill its obligation. For example, if the new primary obligor had little substance, and therefore, would be unable to honor its obligation, the guarantor of that obligation would have to recognize a fair value liability that would likely not differ significantly from the obligation that would be recorded if it were still the primary obligor because of the inability of the new primary obligor to fulfill its obligation. Additionally, the guarantee obligation, initially measured at fair value, reduces the gain or increases the loss recognized from the extinguishment.

Under the financial components approach (ASC 405-20-55-3 through 55-4), an "in-substance defeasance" transaction (for example, where the leased assets and the related obligations are transferred to a trust) does not meet the derecognition criteria for either the asset or the liability since the transaction lacks the following critical characteristics:

- ▶ The lessee is not released from the obligation by putting assets in a trust. If the assets in a trust prove insufficient, for example, because a default by the lessee accelerates its obligation, the lessee is obligated to make the lessor whole.
- ▶ The lessor is not limited to the cash flows from the assets in trust.
- ▶ The lessor does not have the ability to dispose of the assets at will or to terminate the trust.
- ▶ If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the lessee can remove the excess.
- ▶ Neither the lessor nor any of its representatives is a contractual party to establishing the defeasance trust, as holders of interests in a qualifying special-purpose entity or their representatives would be.
- ▶ The lessee does not surrender control of the benefits of the assets because those assets are still being used for the lessee's benefit to extinguish its debt. Because no asset can be an asset of more than one entity, those benefits must still be the lessee's assets.

4.2.3.1

Termination of a capital lease

Termination of a capital lease results in the recognition of a gain or loss for the difference between the remaining asset and obligation balances.

Illustration 4-3: Accounting for the termination of a capital lease

Company X (lessee) has just completed the third year of a 5-year capital lease agreement. The asset under capital lease has a net carrying amount of \$3,000 and the capital lease obligation is \$2,000. If the lease were terminated at the end of year 3 and no termination payments were required to be made, Company X would record a \$1,000 loss on lease termination.

4.2.4 Purchase of a leased asset by the lessee during the term of a capital lease

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Subsequent Measurement

840-30-35-14

The termination of a capital lease that results from the purchase of a leased asset by the lessee is not the type of termination of a capital lease contemplated by paragraph 840-30-40-1 but rather is an integral part of the purchase of the leased asset. If the lessee purchases property leased under a capital lease, any difference between the purchase price and the carrying amount of the capital lease obligation shall be recorded by the lessee as an adjustment of the carrying amount of the asset. However, this paragraph does not apply to leased assets acquired in a business combination or an acquisition by a not-for-profit entity, which are initially measured at fair value in accordance with paragraph 805-20-30-1.

If a termination of a capital lease results from the purchase of a leased asset by the lessee, the purchase and the related lease termination are accounted for as a single transaction. The difference, if any, between the purchase price and the carrying amount of the lease obligation is recorded as an adjustment to the carrying amount of the asset. Consider the following example:

Illustration 4-4: Accounting for the purchase of a leased asset during the term of a capital lease

Company X (lessee) has just completed the third year of a 5-year capital lease agreement. The asset under capital lease has a net book value of \$3,000 and the capital lease obligation is \$2,000. If the lease were terminated at the end of year 3 by the lessee purchasing the asset for \$1,500, Company X would record the following entry:

Capital lease obligation	\$	2,000	
Fixed assets		2,500	
Assets under capital lease			\$ 3,000
Cash			1,500

The asset under capital lease is reclassified as an owned asset and the carrying amount of the asset (\$3,000) is adjusted by the difference between the carrying value of the capital lease obligation (\$2,000) and the purchase price (\$1,500).

In developing the guidance in ASC 840-30-35-14, the FASB noted that lease accounting does not include a requirement for loss recognition on the extension of a capital lease; therefore, the FASB could not include such a requirement related to the purchase of a leased asset during the term of a capital lease (paragraph 4 of FIN 26). The FASB did note that recognition of an impairment loss is not prohibited and we believe it is preferable. Noteworthy is that ASC 840-30-35-14 does not relate to the purchase of an asset by a lessee during the term of an operating lease. See Section 4.3.9 for further details.

4.2.5 Change in lease provisions resulting from refundings of tax-exempt debt

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Subsequent Measurement

840-30-35-10

If, before the expiration of the lease term, a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt (including an advance refunding) in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified by the lessee as a capital lease, the change shall be accounted for as follows:

- a. If, in accordance with the guidance in Subtopic 470-50, that refunding is accounted for as an early extinguishment of debt, the lessee shall do both of the following:
 1. Adjust the lease obligation to the present value of the future minimum lease payments under the revised lease using the effective interest rate applicable to the revised agreement
 2. Recognize any resulting gain or loss currently as a gain or loss on early extinguishment of debt.
- b. If, in accordance with the guidance in Subtopic 470-50, that refunding is not accounted for as an early extinguishment of debt at the date of the advance refunding and the lessee is obligated to reimburse the lessor for any costs related to the debt to be refunded that have been or will be incurred (such as unamortized discount or issue costs or a call premium), the lessee shall accrue those costs by the interest method over the period from the date of the advance refunding to the call date of the debt to be refunded.

840-30-35-11

Example 2 (see paragraph 840-30-55-9) illustrates a lessee's accounting for a capital lease modification involving a refunding of tax-exempt debt.

Tax-exempt debt is often issued by a governmental or quasi-governmental authority to finance the construction of a facility such as a plant or a hospital. The user of the facility either buys the facility or leases it from the authority. The mortgage note or the lease serves as collateral for the tax-exempt debt and payments on the note or lease are the same, as to both amount and timing, as the debt service requirements of the tax-exempt debt. Often, in the case of a lease, title passes at the end of the lease term, thereby meeting one of the criteria for classification as a capital lease.

Many tax-exempt organizations have entered into a refunding by replacing the old debt with new debt to obtain an economic advantage (e.g., lower interest costs) for the lessee or mortgagor. As a result of the refunding, the terms of the related mortgage note or lease are changed to conform with the terms of the new debt issued.

Refundings of tax-exempt debt transactions are excluded from the requirements regarding changes in a lease agreement. Note that when developing the guidance excluding refundings of tax-exempt debt transactions, the FASB specifically elected not to cover refundings that do not involve tax-exempt debt (paragraph 9 of Statement 22). A lessee is required to account for refundings of tax-exempt debt transactions as follows.

ASC 840-30-35-10(a) provides guidance for advance refundings of tax-exempt debt that qualify as early extinguishments of debt (ASC 405-20-40-1 provides criteria for determining when a liability has been considered extinguished – also see Section 4.2.3). The lessee should adjust the capital lease obligation to

the present value of the future minimum lease payments under the revised lease using the effective interest rate applicable to the revised agreement (rather than the interest rate used initially), and recognize any resulting gain or loss currently as a gain or loss on early extinguishment of debt (ASC 840-30-35-10(a)).

ASC 840-30-35-10(b) provides guidance for advance refundings of tax-exempt debt which are not accounted for as early extinguishments of debt (i.e., the advance refunding does not qualify as an extinguishment of debt under ASC 405-20-40-1). If the lessee is obligated to reimburse the lessor for any costs related to the debt to be refunded that have been or will be incurred (e.g., unamortized discount, issue costs, call premium), the lessee shall accrue these costs by the "interest" method over the period from the date of the advance refunding to the call date of the debt to be refunded.

Below is an illustration of the accounting for a refunding transaction by a lessee:

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Implementation Guidance and Illustrations

Example 2: Lessee's Accounting for a Capital Lease Modification Involving a Refunding of Tax-Exempt Debt

840-30-55-9

This Example illustrates a lessee's application of the guidance in paragraph 840-30-35-10 if both the following conditions exist:

- a. A refunding of tax-exempt debt results in a change in the provisions of a lease agreement.
- b. The revised lease is classified as a capital lease by the lessee.

840-30-55-10

The following table summarizes the total debt service requirements of the serial obligation to be refunded and of the refunding obligation. It is presumed that the perceived economic advantages of the refunding result from the lower interest rate applicable to the refunding obligation. The resulting reduction in total debt service requirements will be passed through to the lessee by changing the terms of the related lease to conform with the debt service requirements of the refunding obligation. All costs that have been or that will be incurred by the lessor in connection with the refunding transaction, will be passed through to the lessee.

Fifteen year serial debt service requirements (\$000 omitted):

Obligation to Be Refunded			Refunding Obligation ^(a)			
Face amount	Interest 7%	Total	Face Amount	Interest 5%	Total	Difference
\$ 50,000	\$ 32,300	\$82,300	\$ 52,000	\$ 23,150	\$75,150	\$ 7,150

(a) The face amount of the refunding obligation (\$52,000,000) is equal to the sum of all of the following:

- a. The face amount of the obligation to be refunded (\$50,000,000)
- b. The redemption premium applicable to the obligation to be refunded (\$1,500,000)
- c. The costs of issuance (\$500,000).

840-30-55-11

The following table illustrates the computation of required adjustment to the lease obligation to reflect changes in the terms of the lease resulting from a refunding of tax-exempt debt.

Adjustment to Balance of Lease Obligation:

Present balance of lease obligation under original agreement	\$ 50,000,000
Present value of future minimum lease payments under revised agreement	<u>51,500,000</u>
Adjustment to lease obligation	<u>\$ 1,500,000</u>

840-30-55-12

The following table illustrates the journal entry recording the adjustment to the lease obligation resulting from refunding of tax-exempt debt.

Loss resulting from revision to lease agreement	\$ 1,500,000	
Obligation under capital lease		\$ 1,500,000

840-30-55-13

For purposes of calculating the present value of the future minimum lease payments, deferred issue costs were considered as additional interest in determining the effective interest rate applicable to the revised agreement.

4.3**Operating leases****Excerpt from Accounting Standards Codification****Leases – Operating Leases****Recognition****840-20-25-1**

Rent shall be charged to expense by lessees (reported as income by lessors) over the lease term as it becomes payable (receivable). 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.

840-20-25-2

Certain operating lease agreements specify scheduled rent increases over the lease term that may, for example, be designed to provide an inducement or rent holiday for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements, or to acknowledge the time value of money. This Subtopic, however, differentiates between the following two items:

- a. Scheduled rent increases that are not dependent on future events. Such amounts are minimum lease payments to be accounted for under the preceding paragraph. Scheduled rent increases, which are included in minimum lease payments under Subtopic 840-10, shall be recognized by lessees and lessors on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money, anticipated inflation, or expected future revenues to allocate scheduled rent increases is inappropriate because these factors do not relate to the time pattern of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately.

- b. Contingent rentals. Increases or decreases in rentals that are dependent on future events such as future sales volume, future inflation, future property taxes, and so forth, are contingent rentals that affect the measure of expense or income as accruable, as specified by paragraph 840-10-25-4. If the lessee and lessor eliminate the risk of variable payments inherent in contingent rentals by agreeing to scheduled rent increases, the accounting shall reflect those different circumstances.

840-20-25-3

If rents escalate in contemplation of the lessee's physical use of the leased property, including equipment, but the lessee takes possession of or controls the physical use of the property at the beginning of the lease term, all rental payments by the lessee, including the escalated rents, shall be recognized as rental expense by the lessee (rental revenue by the lessor) on a straight-line basis in accordance with the preceding two paragraphs starting with the beginning of the lease term. This Subtopic considers the right to control the use of the leased property as the equivalent of physical use. If the lessee controls the use of the leased property, recognition of rental expense or rental revenue shall not be affected by the extent to which the lessee uses that property.

840-20-25-4

If rents escalate under a master lease agreement because the lessee gains access to and control over additional leased property at the time of the escalation, the escalated rents shall be considered rental expense by the lessee (rental revenue by the lessor) attributable to the leased property and recognized in proportion to the additional leased property in the years that the lessee has control over the use of the additional leased property.

840-20-25-5

The amount of rental expense (rental revenue) attributed to the additional leased property shall be proportionate to the relative fair value of the additional property, as determined at lease inception, in the applicable time periods during which the lessee controls its use.

840-20-25-6

Lease incentives shall be recognized as reductions of rental expense by the lessee (reductions in rental revenue by the lessor) on a straight-line basis over the term of the new lease in accordance with paragraphs 840-20-25-1 through 25-2.

840-20-25-7

Lease incentives include both of the following:

- a. Payments made to or on behalf of the lessee
- b. Losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party. In that circumstance, the new lessor and the lessee shall independently estimate any loss attributable to that assumption. For example, the lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption. The lessor shall estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed leased property. Example 1 (see paragraph 840-20-55-1) illustrates this guidance.

840-20-25-8

If a build-to-suit lease is classified as an operating lease, the lessee shall consider construction period lease payments made before the beginning of the lease term to be prepaid rent.

Other Presentation Matters

840-20-45-1

Rental costs shall be included in the lessee's income from continuing operations.

Leases that do not meet any of the criteria for capital leases are classified as operating leases. Rentals (excluding contingent rentals) for operating leases generally should be charged to expense using the straight-line method. However, if another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed, that basis should be used. An example would be expensing rental payments for machinery on the units-of-production method when the total units to be produced over the operating lease term can be reasonably estimated. See Section 2.13.2 for discussion of lessee accounting for contingent rent.

4.3.1 Time pattern of use of property in an operating lease

Operating lease agreements may specify scheduled rent increases over the lease term (see Section 2.6), or periods during the lease term for which rent payments are not required (“rent holidays”). Uneven rental payments (increases, decreases or holidays) are often designed to provide an inducement for the lessee, to reflect the anticipated effects of inflation, to ease the lessee’s near-term cash flow requirements or to acknowledge the time value of money. For operating leases that include uneven rental payments or rent holidays, rental expense should be recognized by a lessee on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money or anticipated inflation is inappropriate because these factors do not relate to the physical usage of the leased property.

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

The lessee should recognize the lease payments as follows:

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

The application of the guidance above to an operating lease with uneven rental payments that are not in contemplation of the lessee’s physical use of the property results in prepaid or accrued rentals. If the lessee purchases the leased asset prior to the expiration of the lease term, any prepaid or accrued rentals should be included in the determination of the purchase price of the asset (see Section 4.3.9 for further discussion). In the event the lease agreement is extended, the prepaid or accrued rent should be amortized over the remainder of the extended lease term (see Section 4.3.7 for further discussion).

4.3.1.1 Rent holidays

On 7 February 2005, the SEC posted to its website a letter from the Chief Accountant of the SEC to the AICPA Center for Public Company Audit Firms discussing three lease accounting issues that had been the cause of several public company announced restatements. In the letter, the SEC Chief Accountant discussed the accounting for (1) the amortization of leasehold improvements (Section 4.3.5), (2) rent holidays and (3) landlord/ tenant incentives (Section 4.3.4). The letter also noted that to the extent registrants have deviated from the accounting described, these errors would need to be evaluated for restatement. The issuance of that letter generated numerous questions regarding the accounting for these and related issues. Excerpts from the SEC letter are reflected in italics and serve as the framework for a discussion of the issue.

2. Rent Holidays – The staff believes that pursuant to the response in paragraph 2 of FASB Technical Bulletin 85-3 (“FTB 85-3”), Accounting for Operating Leases with Scheduled Rent Increases, rent holidays in an operating lease should be recognized by the lessee on a straight-line basis over the lease term (including any rent holiday period) unless another systematic and rational allocation is more representative of the time pattern in which leased property is physically employed.

4.3.1.2 Determining lease commencement date

Some have questioned whether the lease term (see Section 2.6) should include periods prior to the lease commencement date stipulated in the lease agreement (i.e., the date rents become due and payable). This question most often arises when the leased space must be modified by the lessee prior to commencing operations in the leased space. ASC 840-20-25-3 (see Section 4.3) notes that the lease term begins when the lessee takes possession of or controls the physical use of the property. See Section 4.3.1, for additional information.

Thus, if a lessee has the right to use or control physical access to the leased property prior to opening for business (e.g., during the leasehold improvement construction period), the lease term has commenced even if the tenant is not required to pay rent and/or the lease arrangement asserts the lease commencement date is a later date. As a result, the straight-line rent computation must include the deemed rent holiday period.

4.3.1.3 Leases that include both scheduled rent increases and contingent rent

Some lease agreements include both scheduled rent increases and contingent rents. In accordance with ASC 840-20-25-2 (see Section 4.3), scheduled rent increases are included in minimum lease payments and should be recognized on a straight-line basis over the lease term; whereas, contingent rentals are excluded from minimum lease payments and should be recognized as incurred (see Section 2.13.2 for further discussion of lessee accounting for contingent rentals). In order to avoid inappropriately recording contingent rents on a straight-line basis in such arrangements, contingent rent expense should be recognized based on the amount by which actual rents in the period differ from the minimum rents for the period (i.e., rents prior to considering the effects of straight-lining scheduled rent increases).

Illustration 4-5: Calculating rent expense when leases contain scheduled rent increases and contingent rent

Lessee A, a retail company, enters into a lease (accounted for as an operating lease) for a 3-year term at annual minimum rents of \$100, \$120, and \$140 in years 1, 2 and 3, respectively. The lease also requires Lessee A to pay additional rents based on a percentage of sales from the leased store location to the extent that the sales-based rents exceed the minimum rents for the year (i.e., annual rent for each year is the greater of the specified minimum rent for the year or 5% of sales for the year). Lessee A should record straight-line rent expense of \$120 $[(100+120+140)/3]$ each year. Assume that in year 1 sales from the leased store location were \$2,200. Lessee A would record contingent rent in year 1 of \$10, calculated as follows:

Sales from leased store location – year 1	\$ 2,200
Percent of sales-based rent	<u>X 5%</u>
	110
Minimum rent for year 1	<u>(100)</u>
Contingent rent	<u>\$ 10</u>

Note that total rent expense for Lessee A in year 1 would be \$130 (straight-line rent of \$120 and contingent rent of \$10). Assuming that sales from the leased store location were \$2,500 and \$2,700 in years 2 and 3, respectively, the rent expense for each year would be as follows:

	<u>Year 2</u>	<u>Year 3</u>
Straight-line rent	\$ 120	\$ 120
Contingent rent	<u>5¹</u>	<u>-²</u>
Total rent expense	<u>\$ 125</u>	<u>\$ 120</u>

¹ Calculated as percent of sales-based rent for year 2 ($\$2,500 \times 5\% = \125) less year 2 minimum rent (\$120).

² No contingent rent as year 3 minimum rent (\$140) exceeds percent of sales-based rent for year 3 ($\$2,700 \times 5\% = \135).

4.3.2

Rent capitalization

Excerpt from Accounting Standards Codification

Leases – Operating Leases

Recognition

840-20-25-10

In some lease arrangements, an entity (lessee) may take possession or be given control of leased property before it commences operations or makes rental payments under the terms of the lease. During this period, the lessee has the right to use the leased property and does so for the purpose of constructing a lessee asset (for example, leasehold improvements). After construction is completed, the lessee commences operations and is required to make rental payments under the terms of the lease. Alternatively, some lease arrangements require the lessee to make rental payments when the lessee takes possession or is given control of the leased property.

840-20-25-11

Rental costs associated with building and ground operating leases incurred during and after a construction period are for the right to control the use of a leased asset during and after construction of a lessee asset. There is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. Therefore, rental costs associated with ground or building operating leases that are incurred during a construction period shall be recognized by the lessee as rental expense. A lessee shall follow the guidance in paragraphs 840-20-25-1

through 25-2 in determining how to allocate rental costs over the lease term. This guidance does not change the application of the maximum guarantee test discussed in paragraph 840-40-55-2. This guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building operating leases.

An end user lessee is prohibited from capitalizing rent under an operating lease into the cost of a constructed asset. Rental costs incurred during and after a construction period are for the right to control the use of a leased asset during and after construction of a lessee asset. There is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. Therefore, rental costs associated with ground or building operating leases that are incurred during a construction period shall be recognized as rental expense. The rental costs should be allocated over the lease term in accordance with the guidance in ASC 840-20-25-1 through 25-2 (see Sections 4.3 and 4.3.1) and included in income from continuing operations.

The guidance in ASC 840-20-25-11 does not address whether a lessee of real estate under development within the scope of ASC 970-360 should capitalize rental costs associated with ground and building operating leases during development. See our Real estate project costs FRD for further discussion on accounting for such costs.

It should be noted that it is not appropriate to defer occupancy costs as a component of start-up activities (ASC 720-15).

4.3.3 Lease incentives in operating leases

An operating lease agreement with a new lessor might include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee's preexisting lease with a third party.

Payments made to or on behalf of the lessee represent incentives that should be considered reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the term of the new lease (ASC 840-20-25-6 – see Section 4.3). Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered an incentive by both the lessor and the lessee. Incentives should be recognized on a straight-line basis over the term of the new lease. The lessor and the lessee should independently estimate any loss attributable to the assumption of a preexisting lease with a third party. For example, the lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption, and the lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed leased property (ASC 840-20-25-7 – see Section 4.3).

4.3.4 Landlord/tenant incentives

Excerpt from Accounting Standards Codification

Leases – Operating Leases

Implementation Guidance and Illustrations

840-20-55-1

The lessee's immediate recognition of expenses or losses, such as moving expenses (as required by paragraphs 420-10-25-14 through 25-15), losses on subleases (as required by paragraph 840-20-25-15), or the write-off of abandoned leasehold improvements (as required by paragraph 360-10-45-15), is not changed by the lessor's assumption of those expenses or losses.

840-20-55-2

This Example addresses the question of when the lessee should recognize the incentive related to the new lessor's assumption of those expenses or losses.

840-20-55-3

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

Lessee Accounting

At inception:

Loss on sublease assumed by lessor	\$	960	
Incentive from lessor			\$ 960
<i>To record loss on sublease assumed in conjunction with new lease agreement</i>			

Recurring journal entries in Years 1-8:

Lease expense	\$	1,080	
Incentive from lessor (960 ÷ 8 years)		120	
Cash			\$ 1,200
<i>To record cash payment on new lease and amortization of incentive over the new lease term</i>			

[Note: Lessor accounting has been excluded. See Section 5.3.3 for lessor accounting]

On 7 February 2005, the SEC posted to its website a letter from the Chief Accountant of the SEC to the AICPA Center for Public Company Audit Firms discussing three lease accounting issues that had been the cause of several public company announced restatements. In the letter, the SEC Chief Accountant discussed the accounting for (1) the amortization of leasehold improvements (Section 4.3.5), (2) rent holidays (Section 4.3.1.1) and (3) landlord/tenant incentives. The letter also noted that to the extent registrants have deviated from the accounting described, these errors would need to be evaluated for restatement. The issuance of that letter generated numerous questions regarding the accounting for these and related issues. Excerpts from the SEC letter are reflected in italics and serve as the framework for a discussion of the other issues.

3. Landlord/Tenant Incentives – *The staff believes that: (a) leasehold improvements made by a lessee that are funded by landlord incentives or allowances under an operating lease should be recorded by the lessee as leasehold improvement assets and amortized over a term consistent with the guidance in item 1; (b) the incentives should be recorded as deferred rent and amortized as reductions to lease expense over the lease term in accordance with paragraph 15 of SFAS 13 and the response to Question 2 of FASB Technical Bulletin 88-1 ("FTB 88-1"), Issues Relating to Accounting for Leases, and therefore, the staff believes it is inappropriate to net the deferred rent against the leasehold improvements; and (c) a registrant's statement of cash flows should reflect cash received from the lessor that is accounted for as a lease incentive within operating activities and the acquisition of leasehold improvements for cash within investing activities. The staff recognizes that evaluating when improvements should be recorded as assets of the lessor or assets of the lessee may require significant judgment and factors in making that evaluation are not the subject of this letter.*

The potential accounting effects of improperly netting lease incentives, in the form of subsidized leasehold improvements, with the accounting for the lease include misstatements of impairments, and failures to properly gross up balance sheets, income statements, and the statements of cash flows. The accounting for incentives is discussed in ASC 840-20-25-6 (see Section 4.3) and in Section 4.3.3.

4.3.4.1 What types of items qualify as incentives?

An operating lease agreement with a new lessor may include incentives for the lessee to enter into the lease, such as an up-front cash payment to the lessee, payment of certain costs for the lessee (such as moving expenses or leasehold improvements) or the assumption by the lessor of the lessee's preexisting lease with a third party. As indicated in ASC 840-20-25-7 (see Section 4.3), payments made to, or on behalf of, the lessee represent incentives that should be considered reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the term of the lease. Incentives should be recognized on a straight-line basis over the term of the lease (as reductions of rent expense for lessees) and excluded from minimum lease payments for determining lease classification.

When a lessee receives an upfront payment from the lessor to fund (or partially fund) tenant improvements, the incentive is recorded as an obligation payable to the lessor (i.e., a debit to cash and an offsetting credit to lease incentive obligation). As payments are made to the landlord under the lease, a portion (incentive ÷ lease term) of those payments are, in substance, repayments of the incentive (that is, a debit to the lease incentive obligation and an offsetting credit to cash). The fact that the incentive received by the tenant is earmarked specifically to reimburse the lessee for the cost of the new leasehold improvements does not impact the accounting for the acquisition of the lessee's leasehold improvements. That is, even if the funding is designated to partially or fully fund the lessee's leasehold improvements, leasehold improvements are still recorded at full cost on the lessee's books. This accounting would also apply if, instead of receiving and paying cash, the lessee simply submits invoices to the lessor for a prescribed amount of leasehold improvements that the lessor has agreed to fund.

Illustration 4-6: Accounting for lease incentives

Lessee A, a retail company, enters into a lease (accounted for as an operating lease) with Lessor B (a mall owner) for a 5-year term at a monthly rental of \$110. In order to induce Lessee A to enter into the lease, Lessor B agrees to provide funding of up to \$500 for leasehold improvements. Lessee A spends \$700 on leasehold improvements. Lessee A would make the following entries:

To record the receipt of the incentive:

Cash	\$	500	
Lease incentive obligation			\$ 500

To record the expenditure of funds (including \$500 of funds supplied by the landlord) on leasehold improvements:

Leasehold Improvements	\$	700	
Cash			\$ 700

For simplicity, the value of the incentive has been assumed to be the upfront cash payment. Note that if instead of receiving and paying cash the lessee simply submits \$500 of bills to the lessor for payment directly by the lessor, the net entry by the lessee (i.e., recognition of leasehold improvements and a lease incentive obligation) would still be the same. That is, the \$500 incentive and leasehold improvement would still be recorded, although it would be a non-cash charge for cash flow reporting.

To record monthly lease payments:

Operating lease expense	\$	102	
Lease incentive obligation		8	
Cash			\$ 110

To record monthly amortization expense on leasehold improvements (amortized over the shorter of the lease term or estimated useful life):

Amortization expense	\$	11	
Accum. amort. of leasehold improvements			\$ 11

4.3.4.2

Who owns the improvements?

In many instances, judgment will have to be applied to determine whether the lessee is constructing leasehold improvements or leasing built-out space. For example, if a retailer leases general purpose retail space and has its own contractor build out its specific improvements so that consistency is maintained on a nationwide basis, the lessor providing a contribution for a portion of the costs will generally be viewed as an incentive. In contrast, a lessee who contracts with a lessor to lease fully built-out space to the lessee of a general purpose nature (e.g., a floor in an office building with interior walls and lighting) may be leasing fully built space. Illustrative factors that would be considered in making this determination include:

- ▶ What happens to the improvements at the end of the lease term (removed or preserved for the landlord),
- ▶ How unique are the improvements (e.g., the décor and logo of a national retail chain versus general purpose improvements),
- ▶ Which party is supervising construction and bears the risk of cost overruns,
- ▶ Which party bears all costs of the improvements, and
- ▶ Who is the owner of the improvements?

In considering these factors, it should be noted that it is inconsistent with the unit of accounting concept to recognize a partial asset in the lessee's financial statements (e.g., lessor funds 60% of an asset and the lessee recognizes 40% as an asset in the lessee's financial statements). Also noteworthy, is that while the above listed factors may be helpful, individual lessees (and lessors) will each have their own specific accounting policies that should be applied on a consistent basis.

In addition, determinations that are made in differentiating lease incentives from leases of fully built-out space should be consistent with the determination of the start of the lease (see Section 4.3.1) as well as accounting for asset retirement obligations and minimum lease payments. As noted in Section 2.9.1.6, an obligation to remove improvements at the end of the lease term is either an asset retirement obligation (removal of tenant improvements) or a component of the minimum lease payments (required modifications to leased assets).

4.3.4.3 Considerations when lessor owns improvements

Another consideration in this regard is that if a lessee is considered to be leasing fully built-out space, the transaction could be subject to the provisions for lessee involvement in asset construction under ASC 840-40-15-5 (see Section 10.1), which will often result in the lessee recording the leased asset on its books during construction (if for instance the lessee bears the risk of cost overruns) and then being subject to the real estate sale-leaseback provisions under ASC 840-40 on completion. For example, if the lessor and lessee fund 60% and 40%, respectively, of the costs of building property to be leased to the lessee, and pursuant to ASC 840-40-15-5, the lessee is deemed the accounting owner of the improvements during the construction phase, the lessee's contribution of 40% of the leasehold improvements cost will generally be considered a form of continuing involvement (e.g., a non-recourse loan or prepaid rent/collateral to the buyer-lessor), which may preclude recognition of the deemed sale on completion of the construction project. See Section 10 for further details, including associated scope exceptions.

4.3.5 Amortization of leasehold improvements

Excerpt from Accounting Standards Codification

Leases – Overall

Subsequent Measurement

840-10-35-6

Leasehold improvements in operating leases that are placed in service significantly after and not contemplated at or near the beginning of the lease term shall be amortized over the shorter of the following terms:

- a. The useful life of the assets
- b. A term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the context of the definition of lease term) at the date the leasehold improvements are purchased.

840-10-35-7

The guidance in the preceding paragraph does not apply to preexisting leasehold improvements and, thus, shall not be used to justify the reevaluation of the amortization period for preexisting leasehold improvements for additional renewal periods that are reasonably assured when new leasehold improvements are placed into service significantly after and are not contemplated at or near the beginning of the lease term.

840-10-35-8

The guidance in the preceding two paragraphs does not address the amortization of intangible assets that may be recognized in a business combination for the favorable or unfavorable terms of a lease relative to market prices.

840-10-35-9

Paragraph 805-20-35-6 requires that leasehold improvements acquired in a business combination or an acquisition by a not-for-profit entity be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the definition of lease term) at the date of acquisition.

On 7 February 2005, the SEC posted to its website a letter from the Chief Accountant of the SEC to the AICPA Center for Public Company Audit Firms discussing three lease accounting issues that had been the recent cause of several public company announced restatements. In the letter, the SEC Chief Accountant discussed the accounting for (1) the amortization of leasehold improvements (2) rent holidays (Section 4.3.1.1) and (3) landlord/ tenant incentives (Section 4.3.4). The letter also noted that to the extent registrants have deviated from the accounting described, these errors would need to be evaluated for restatement. The issuance of that letter generated numerous questions regarding the accounting for these and related issues. Excerpts from the SEC letter are reflected in italics and serve as the framework for a discussion of the related issues.

1. Amortization of Leasehold Improvements – The staff believes that leasehold improvements in an operating lease should be amortized by the lessee over the shorter of their economic lives or the lease term, as defined in paragraph 5(f) of FASB Statement 13 (“SFAS 13”), Accounting for Leases, as amended. The staff believes amortizing leasehold improvements over a term that includes assumption of lease renewals is appropriate only when the renewals have been determined to be “reasonably assured,” as that term is contemplated by SFAS 13.

4.3.5.1

Leasehold improvements placed in service at or near lease inception

The following examples provide a brief overview of the accounting for leasehold improvements placed in service (or contemplated) at or near lease inception and stress that the accounting for leasehold improvements (placed in service or contemplated at or near lease inception) that cannot be easily removed and used elsewhere must be consistent with the accounting for the underlying lease. That is, such leasehold improvements that cannot be easily removed and used elsewhere should be amortized over the shorter of their estimated useful life or the initial operating lease term as defined in the ASC Master Glossary (also see Section 2.6). Obligations to remove leasehold improvements are not the subject of this discussion but the accounting for such obligations can be found in Section 2.9.1.6.

Illustration 4-7: Accounting for leasehold improvements when a lessee leases land and constructs building

Lessee leases undeveloped land and constructs a retail building (the leasehold improvement) on the site. The land lease is for an initial term of 20 years with two 5-year renewal options that are at higher rates than applicable during the initial term. The first issue is what is the lease term? The lease term includes renewal periods when the penalty for failure to renew is so large that there is reasonable assurance at the lease inception date that the lease will be renewed. The penalty (as further described in Section 2.6.1) includes, but is not limited to, the value of leasehold improvements that would be impaired by the lessee vacating the building. In this example, surrendering the building at the end of 20 or 25 years (whether turned over to the lessor or torn down) would be included as part of the penalty subject to analysis. If it is determined that the land lease term is 20, 25 or 30 years, minimum lease payments would be required to be straight-lined over the lease term (see Sections 4.3 and 4.3.1 for further discussion). In this example, an analysis of capital or operating lease under the 90% fair market value and 75% useful life tests is not required as they are not applicable to a lease of land only (see Section 6.2 for further discussion of lease classification of leases of land only).

The lease term not only determines the straight-line rental that should be recorded under an operating lease but we believe it also sets forth the maximum useful-life for amortization of those leasehold improvements that are placed in service or contemplated at or near lease inception and that cannot be easily removed and used elsewhere. We believe the amortization period for such leasehold improvements is limited to the lesser of the initial lease term (as defined above, which would include renewal periods when there is a compulsion to renew as a result of a penalty – see Section 2.14) or the useful life of the asset(s).

Illustration 4-8: Accounting for leasehold improvements when a lessee leases retail space and constructs leasehold improvements

A lessee leases retail space (e.g., an already constructed building or portion of a building) for a 10-year initial term with two 5-year renewal options. The lessee makes extensive leasehold improvements (façade, flooring, counters, etc.). Consistent with Illustration 4-7, surrendering the leasehold improvements at the end of 10 or 15 years would be included as part of the penalty subject to analysis. If it is determined that the lease term is 10 or 15 years, minimum lease payments would be required to be straight-lined over that lease term if an operating lease (see Sections 4.3 and 4.3.1) as well as factored into the capital lease analysis (the 90% fair market value and 75% useful life tests). It should be noted that a practical exception for a lease of a portion of a building from the 90% fair market value test is often available (see Section 6.5 for further details). The lease term not only determines the straight-line rental that should be recorded under an operating lease (as well as the determination of whether the lease is capital or operating) but we believe it also sets forth the maximum useful-life for amortization of leasehold improvements placed in service (or contemplated) at or near the inception of the lease (that cannot be easily removed and used elsewhere). We believe the amortization period for leasehold improvements placed in service (or contemplated) at or near the inception of the lease that cannot be easily removed and used elsewhere is limited to the lesser of the initial lease term (which would include renewal periods when there is a compulsion to renew as a result of a penalty) or the asset(s) useful life. If the lease of the retail space is a capital lease, we believe amortization of the leasehold improvements should also be restricted to the lesser of the estimated useful life of the asset(s) or the initial lease term used for accounting purposes unless the lease contains an automatic transfer of ownership of the leased property (building) or a bargain purchase option in which case the leasehold improvements would simply be amortized over their useful life.

4.3.5.2

Leasehold improvements placed in service subsequent to lease inception

As noted in ASC 840-10-35-6 (see Section 4.3.5), leasehold improvements added subsequent to the inception of a lease (e.g., in the 8th year of a 10-year lease) should be amortized over the lesser of the useful life of the assets or over a term that includes renewals that are reasonably assured at the date the leasehold improvements are purchased. For example, Retailer A enters into a 10-year lease with a 5-year renewal option. At the inception of the lease the retailer determined that the lease term was ten years (the 5-year renewal was not determined to be reasonably assured). Leasehold improvements placed in service at or near lease inception are amortized over the shorter of their useful life or ten years. In year 8, the retailer remodels the store and adds extensive leasehold improvements. The leasehold improvements added in year 8 should be amortized over the shorter of their useful life or the term (determined at that time) that includes renewals that are reasonably assured. If the retailer in year 8 determines that due to economic (profitability of location, bargain renewal rates, lack of alternate locations, abandoning leasehold improvements, etc.) or other penalties that it would be reasonably assured of renewing the lease, the retailer would amortize the leasehold improvements added in year 8 over the shorter of their useful life or 7 years. Judgment is required to analyze these situations, including the nature of the expenditures, to determine the appropriate amortization period. However, the renewal period cannot be accounted for under the lease until the renewal option (that was not included in the original lease term used for accounting purposes) is actually exercised (see Section 3.4). The amortization period (original 10-year term) for those leasehold improvements that were placed into service (or contemplated) at or near inception of the lease should not be extended, even if a renewal that was excluded from the original lease term subsequently becomes reasonably assured of renewal, unless the renewal option is in fact exercised as described in ASC 840-10-35-4 (see Section 3.4) (creating a new lease agreement).

While there are no bright lines for determining how much time should elapse in order for a different determination of renewals being reasonably assured for leasehold improvements added after lease inception versus the determination as of the inception of the lease, we believe that the lessee should be able to point to substantial changes such as remaining lease term, market conditions, renewal rates versus market, availability of replacement facilities, profitability of location and fair value of abandoned leasehold improvements to substantiate why a change has occurred. Ordinarily a significant period of time would have to elapse for such a change not to have been contemplated at lease inception.

4.3.5.3 Leasehold amortization beyond lease option period

We understand that in certain industries companies will make investments in leasehold improvements late in the life of a lease when the lessee does not possess any contractual renewal options (e.g., year 8 of a 10-year lease). We believe it would be extremely rare that it would be concluded that the amortization period would ever extend beyond periods in which a lessee has an option to renew. That is, in almost all cases, it would be inappropriate for a lessee to assume a renewal is reasonably assured if a contractual renewal option does not exist.

4.3.5.4 Salvage values

The amortization of leasehold improvements should take into account any net salvage value that would accrue to the lessee.

4.3.5.5 Leasehold improvements acquired in business combinations

ASC 840-10-35-5 (see Section 13) applies to accounting for leases by a combined company at the date of, and subsequent to, a business combination. ASC 840-10-35-5 provides that the classification of a lease in accordance with the criteria of ASC 840 is not to be changed (nor should the lease term – see Section 2.6) as a result of a business combination unless the provisions of the lease agreement are modified.

As indicated in ASC 840-10-35-4 (see Section 3.4), once the classification of a lease is determined, that classification is not changed unless:

1. Both parties to the lease agree to a revision that would have resulted in a different classification had the changed terms been in effect at the inception of the lease

Or

2. The lease is extended or renewed beyond the existing lease term

ASC 840-10-35-5 does not, however, deal with the amortization period of acquired leasehold improvements. An asset acquired in a business combination is similar to a leasehold improvement placed in service subsequent to lease inception (as described in Section 4.3.5.2) and, as such, the asset should be amortized over the shorter of the useful life or the term (determined at the date the business combination is recorded) that includes renewals that are reasonably assured (ASC 840-10-35-9 – see Section 4.3.5). However, any renewal period not included in the lease term as determined by the acquired company cannot be accounted for under the lease until the renewal option is exercised (see Section 3.4 for further details).

4.3.5.5.1 Asset acquisitions

We have seen numerous instances in which a company has a land lease assigned to them (as lessee) and purchases leasehold improvements in asset acquisitions (versus business combinations). In such a transaction, we believe it is appropriate for the lessee to treat the land lease as a new lease and the asset acquired as a leasehold improvement placed in service at or near lease commencement (the accounting described in Section 4.3.5.1). See Section 13 for additional discussion.

4.3.5.5.2 *Fresh start accounting*

In general the accounting for leasehold improvements that have been revalued in fresh start accounting should follow the guidance for business combinations noted in Section 4.3.5.5.

4.3.6 **Guaranteed residual value in an operating lease**

Excerpt from Accounting Standards Codification

Leases – Operating Leases

Recognition

840-20-25-12

For guidance on a lessee's initial recognition of a liability at the inception of an operating lease for any guarantee by the lessee of the leased property's residual value, see Topic 460. Paragraph 460-10-55-23(d) provides guidance on the offsetting entry.

840-20-25-13

Although the maximum deficiency under the residual value guarantee is included in minimum lease payments for purposes of lease classification under paragraph 840-10-25-1(d), those payments would not be considered in the rentals to be charged to expense over the lease term as required by paragraph 840-20-25-1 unless and until it becomes probable that the value of the property at the end of the lease term will be less than the residual value guaranteed by the lessee. In that circumstance, the lessee-guarantor is required to recognize a liability using the straight-line method over the remaining term of the lease.

Initial Measurement

840-20-30-1

For guidance on a lessee's initial measurement of a liability at the inception of an operating lease for any guarantee by the lessee of the leased property's residual value, see paragraph 460-10-30-2(b).

Subsequent Measurement

840-20-35-1

Paragraph 460-10-30-2(b) requires the lessee-guarantor to measure the liability for a residual value guarantee initially at its fair value at lease inception even if no residual value deficiency is probable. Beginning on the date the deficiency becomes probable, the expected deficiency (up to the maximum for which the lessee is responsible) shall be accrued by the lessee-guarantor using the straight-line method over the remaining term of the lease. A lessee-guarantor shall accrue a deficiency whether or not the lessee expects to exercise a purchase or renewal option at the end of the lease term. If no payments for a residual value deficiency are ultimately due under the guarantee, it is possible that subsequent measurement of the liability may not affect the guarantor-lessee's earnings for each reporting period over the lease term, depending on the lessee-guarantor's accounting policy for subsequent measurement of the liability.

Under ASC 460, *Guarantees*, the guarantor (e.g., the lessee that provides the residual value guarantee) is required to recognize a liability for the obligation at its fair value at inception of the guarantee. For residual value guarantees (see Section 2.9.2) issued in connection with an operating lease, fair value represents the premium that would have been received had the guarantee been issued in a standalone transaction. Because quoted market prices in active markets are not likely to be available, many entities will be required to estimate the fair value of a residual value guarantee based on the expected present

value of contingent payments under the guarantee arrangement in accordance with the principles of ASC 820, *Fair Value Measurement*. The framework for fair value measurement prescribed in ASC 820 should be applied to determine the fair value of the liability under ASC 460. However, it should be noted that ASC 820 does not eliminate the practicability exception that currently exists in ASC 460 with respect to fair value measurement when a premium is received or receivable. See our Fair value measurements and disclosures FRD for further discussion on determining fair value of a guarantee.

ASC 460 does not prescribe a specific account for the lessee/guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee. However, ASC 460-10-55-23(d) provides an illustration of a residual value guarantee issued in connection with an operating lease and suggests that the offsetting entry to create the liability in a lease arrangement should be to prepaid rent, which we believe is appropriate. The subsequent accounting for the prepaid rent should be consistent with the guidance in ASC 840-20, which requires prepaid rent to be amortized on a straight-line basis over the term of the lease. It should be noted that the additional rental expense that results from the guarantee should not be included in the determination of the lease classification under ASC 840-10-25-1 (see Section 3.2). As noted in Section 2.9.2, the lessee should include their guarantee of the residual value in the minimum lease payments, and therefore it would be inappropriate to also include the fair value of the same guarantee.

The lessee should subsequently account for the liability related to the residual value guarantee by reducing the liability as it is released from risk. Two methods noted in ASC 460 that are used to measure and recognize reductions in risk for residual value guarantees in an operating lease include:

- ▶ Upon expiration or settlement of the guarantee
- ▶ By a systematic and rational amortization method

Determining how and when risk is released from the residual value guarantee (or other guarantees within the scope of ASC 460) will be based on individual facts and circumstances. If a systematic and rational amortization method is used and it becomes probable that the lessee will be required to make a payment under the residual value guarantee, the lessee should increase the liability recorded under the guidance in ASC 460 with a corresponding increase to prepaid rent. The lessee should then amortize the increase in prepaid rent over the remaining lease term.

Note that the guidance in ASC 460 was codified primarily from FIN 45, which is effective for guarantees entered into or modified after 31 December 2002. For residual value guarantees entered into prior to the effective date of FIN 45 that are not subsequently modified, the accounting guidance provides that the residual value guarantee should be accrued by the lessee over the remaining lease term when it becomes probable that the guarantee will result in a liability. Any revision in the estimate of the amount of the liability should be recognized over the remaining lease term.

4.3.7 Renewal or extension of an operating lease

An existing lease is considered a new lease agreement for accounting purposes when it is renewed or extended beyond the original lease term (see Section 2.6 for further discussion of lease term). The exercise of a renewal option included as part of the original lease term does not create a new lease for accounting purposes as that renewal was already included in the existing lease accounting (e.g., included in the assessment of lease classification and determining straight-line rentals). However, the exercise of a renewal option that was not deemed part of the original lease term, or entering into a new agreement that goes beyond the original lease term, would automatically create a new lease for accounting purposes (see Section 3.4 for further details).

A new lease for accounting purposes should be classified as an operating or capital lease at the date of the renewal or extension using the revised terms that exist at the date of the modification (i.e., the date of the renewal or extension). The term of the new lease consists of the remaining term of the existing lease plus any extension or renewal period.

4.3.7.1

Accounting for a deferred rent credit when an operating lease is extended or renewed

When an operating lease is extended or renewed, the lessee is considered to have entered into a new lease for accounting purposes. As a result, questions have arisen regarding the accounting for any deferred rent credits recorded for the original lease.

Exercise of renewal option

If the term of an operating lease is extended (e.g., original lease term of 24 months is extended to 36 months), any deferred rent credit (whether related to a straight-line rental adjustments or a lease incentive) or prepaid rent should be amortized over the remaining term of the revised lease so that the new lease also reflects straight-line rent. It would be inappropriate to record as income any deferred rent credit at the time of extension or renewal.

Illustration 4-9: Accounting for a deferred rent credit when a lease is renewed

Retailer A enters into a 10-year operating lease with a 5-year renewal option. At the inception of the lease the retailer determined that the lease term was ten years. In year 8, the retailer extends the lease by exercising the renewal option at which point the lessee is obligated for a 7-year lease (5-year renewal plus 2 years of remaining original lease term). Assuming the new lease (i.e., the 7-year lease) is an operating lease, any deferred credit related to an incentive under the prior lease or escalating rental payments should be included in the calculation of straight-line rentals for the new 7-year lease term. That is, it would be inappropriate to record as income the deferred credit under the prior lease when entering into a new lease with the same landlord.

Lease extension

The above accounting would also be followed if a renewal option was not available in the original lease and the lease is instead extended through a new agreement.

Illustration 4-10: Accounting for a deferred rent credit when a lease is extended

Retailer A enters into a 10-year lease with no renewal options. In year 8, the retailer and lessor negotiate a new 7-year lease. The entering into of a 7-year lease in year 8 would be considered a new lease for accounting purposes. Assuming the new lease (i.e., the 7-year lease) is an operating lease, any deferred credit related to an incentive or escalating rental payments under the prior lease should be included in the calculation of straight-line rentals for the new 7-year lease term. It would be inappropriate to record as income the deferred credits under the prior lease when entering into a new lease with the same landlord.

4.3.8

Change in operating lease other than extending the lease term

A change in an operating agreement other than to extend the lease term that results in a new lease (see Section 3.4.1) should be accounted for as follows:

1. If the original lease is classified as an operating lease and the new lease is classified as a capital lease, the new lease should be accounted for as a capital lease at the date of the change in the lease terms.

2. If the original lease and the new lease are both operating, see Section 4.3.8.1. If Section 4.3.8.1 is not applicable (for example when the lease term is not shortened), the new lease would be accounted for with rents reflected on a straight-line basis (see Section 4.3).

4.3.8.1

Modifications to an operating lease that do not change the lease classification

Excerpt from Accounting Standards Codification

Leases – Operating Leases

Implementation Guidance and Illustrations

840-20-55-4

This guidance addresses how, in the circumstances described, the adjustment to the lease term and the increase in the lease payments over the shortened lease period should be accounted for by the lessee. An entity leases an asset under an operating lease for use in its operations. Before the expiration of the original lease term, the lessee and lessor agree to modify the lease by shortening the lease term and increasing the lease payments over the shortened lease period. The modifications do not change the lease classification and no other changes are made to the lease.

840-20-55-5

The treatment by the lessee of the increase in the lease payments over the shortened lease period is a matter of judgment that depends on the relevant facts and circumstances. If the increase is, in substance, only a modification of future lease payments, the increase should be accounted for by the lessee prospectively over the term of the modified lease as discussed in paragraph 840-20-25-1. If the increase is, in substance, a termination penalty, it should be charged by the lessee to income of the period of the modification as discussed in by paragraphs 420-10-30-8 through 30-9. Factors to consider in determining the nature of the increase include both of the following:

- a. The term of the modified lease as compared with the remaining term of the original lease. The shorter the term of the modified lease is in comparison to the remaining term of the original lease, the more likely it is that the increase in the lease payments represents a termination penalty.
- b. The relationship of the modified lease payments to comparable market rents. The closer the modified lease payments are to comparable market rents, the more likely it is that the increase in the lease payments represents a modification of future lease payments.

840-20-55-6

If the increase in the lease payments represents a termination penalty, the amount of the charge should be calculated by the lessee as the excess of the modified lease payments over the lease payments that would have been required over the shortened period under the original lease. The amount to be recognized by the lessee may be based on either undiscounted or discounted amounts provided that the accounting policy is consistently applied and disclosed in accordance with Topic 235.

ASC 840-20-55-4 through 55-6 addresses the accounting by the lessee for shortening the lease term and increasing the lease payments over the revised lease period. These provisions do not apply to lessors.

Illustration 4-11: Accounting for a shortening of the lease term and an increase of lease payments

At the end of the third year of an 8-year operating lease of a shipping container, the lessor and lessee agree to shorten the lease term to five years and increase the remaining (24) monthly lease payment from \$45 to \$60. The shortening of the lease term and the increase of lease payments represents a termination penalty of \$360 $((\$60 - \$45) \times 24 \text{ months})$ that should be recorded by the lessee as of the lease revision, on either an undiscounted or discounted basis (depending on the company's past policy).

4.3.8.2 Change in lease payment index

Some lease agreements permit that on exercise of its rights under an existing lease, a lessor or lessee may request that rent be computed on some other basis (factor or index) than was used at the inception of the lease (e.g., LIBOR-based rate to a mortgage-based rate). If the lease agreement requires that both the lessor and lessee consent to such change or involves a payment by the lessee to the lessor or its lenders to make the change, this constitutes a modification to the terms of the lease, as described in ASC 840-10-35-4 (see Section 3.4), as one party cannot change the terms without agreement or payment by another party. If this modification to the terms of the lease results in a new lease (see Section 3.4.1), the new lease should be accounted for in accordance with Section 4.3.8.

4.3.8.3 Accounting for a deferred rent credit when lessee obtains expanded or similar lease space

Expanded lease space

We believe the accounting detailed in Section 4.3.7.1 related to a renewal or extension of a lease would also be appropriate if the lessee enters into a new lease for expanded rental space. That is, whether the expansion of lease space is negotiated in conjunction with the exercise of a renewal option or the negotiation of a new lease, the lessee is continuing to lease the preexisting space and any deferred rent credit (whether related to a straight-line rental adjustment or a lease incentive) or prepaid rent should be amortized over the term of the new operating lease so that the new lease also reflects straight-line rent.

Illustration 4-12: Accounting for a deferred rent credit when a lessee obtains expanded lease space

Retailer A enters into a 10-year operating lease with no renewal options. Retailer A experiences significant growth and has changed their marketing strategy such that they require a larger footprint for their retail locations. In year 8, the retailer and lessor negotiate a new 7-year lease for the existing space as well as an expansion into the adjoining store. The entering into of a 7-year lease in year 8 would be considered a new lease for the existing space for accounting purposes as well as the adjoining space. Assuming the new lease (i.e., the 7-year lease) is an operating lease, any deferred credit related to an incentive or escalating rental payments under the prior lease should be included in the calculation of straight-line rentals for the new 7-year lease term. It would be inappropriate to record as income the deferred credits under the prior lease when entering into a new lease with the same landlord.

Similar lease space

Occasionally a lessee will terminate an operating lease with a landlord and at the same time enter into a new operating lease for similar, but not the same, lease space. In these instances, a question arises as to whether any deferred credit on the preexisting lease should be recognized as income or instead be treated as a component of the new lease. We believe that it is most appropriate to account for any deferred credit on a lease that is early terminated in conjunction with entering into a new lease with the same landlord as part of the new lease rather than recognizing a gain on termination. This view is supported in that it accounts for the surrender of the credit on the existing space as consideration for entering into the lease on the new space. It is also similar to the accounting for a gain in a sale-leaseback where the gain is deferred over the subsequent accounting lease term.

Illustration 4-13: Accounting for a deferred rent credit when a lessee obtains similar lease space

Retailer A enters into a 10-year operating lease. Retailer A experiences significant growth and has changed their marketing strategy such that they require a larger footprint for their retail locations. In year 8, the retailer and lessor negotiate a new 7-year operating lease for a retail location in another portion of the mall while at the same time terminating the existing lease. The 7-year lease entered into in year 8 would be considered a new lease. Assuming the new lease (the 7-year lease) is an operating lease, any deferred credit related to an incentive or escalating rental payments under the prior lease should be included in the calculation of straight-line rentals for the new 7-year lease term and space. It would be inappropriate to record as income the deferred credits under the prior lease when entering into a new lease for similar space with the same landlord.

In some instances, such as when a lessee enters into a new lease for significantly different space with the landlord (e.g., retail space in a different city or class A vs. B office space) or has incurred significant expense in making a move at the request of the landlord (e.g., early write-off of significant leasehold improvements), alternative accounting may be allowable if objective evidence of the fair value of the separate elements is available.

4.3.9 Purchase of a leased asset by the lessee during the term or at the expiration of an operating lease

Acquired assets should be initially recognized at the lower of cost or fair value on the acquisition date. Thus, if a lessee purchases an asset subject to an operating lease during the lease term, the lessee/buyer should record the asset at the lesser of the purchase price or the asset's then-current fair value. Any excess of purchase price paid over the fair value of the leased asset is immediately recognized in earnings as a cost to terminate the operating lease. If a lessee purchases an asset at the expiration of an operating lease based on the terms of a fixed price purchase option, it is necessary to separate such consideration between the fair value of the asset acquired and any liability under the operating lease, such as a liability under a residual value guarantee that must be recognized at or prior to purchase. It is inappropriate to include a liability related to the operating lease (such as a liability under a residual value guarantee) in the basis of the acquired asset. This conclusion is consistent with the requirement to recognize a loss in EITF 04-1, which has been carried forward to ASC 805, *Business Combinations*.

4.3.10 Lease termination costs related to exit or disposal activities

Excerpt from Accounting Standards Codification

Exit or Disposal Cost Obligations – Overall

Recognition

420-10-25-11

For purposes of this Subtopic, costs to terminate an operating lease or other contract are either of the following:

- a. Costs to terminate the contract before the end of its term
- b. Costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity.

This Section focuses on the accounting for lease termination costs that are incurred as part of an exit or disposal activity. ASC 420, *Exit or Disposal Cost Obligations*, only addresses termination costs for contracts, such as operating leases and other executory contracts, in connection with exit or disposal activities. ASC 420 does not address the accounting for costs to terminate a contract that is a capital

lease. The termination of a capital lease is discussed in Section 4.2.3.1 in this publication. For additional information on the scope of ASC 420 (and the definition of exit and disposal activities), see our Exit or disposal cost obligations FRD.

The accounting for lease termination costs is discussed in the following sections.

4.3.10.1

Costs to terminate a contract

Excerpt from Accounting Standards Codification

Exit or Disposal Cost Obligations – Overall

Recognition

420-10-25-12

A liability for costs to terminate a contract before the end of its term shall be recognized when the entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty).

Initial measurement

420-10-30-7

A liability for costs to terminate a contract before the end of its term shall be measured at its fair value when the entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty).

A liability for costs to terminate a lease before the end of its term should be recognized and measured at fair value (in accordance with ASC 820, *Fair Value Measurement*) when an entity terminates the lease in accordance with the lease terms (for example, when the entity gives written notice to the lessor within the notification period specified by the lease or has otherwise negotiated a termination with the lessor). In discussing this provision, the FASB concluded that having exercised its option to terminate a contract by communicating that decision to the counterparty, an entity has a legal obligation under the contract to pay the penalty or other costs specified by the contract. Consider the following example.

Illustration 4-14: Determining the termination date

Lessee A has leased under an operating lease a floor in a building for an 8-year term. Three years into the lease term, Lessee A determines that it no longer needs the leased space. As a result, Lessee A negotiates with the lessor and commits to a buyout effective at the end of year 3. The terms of the buyout are legally binding on both Lessee A and the lessor. As a result, Lessee A must accrue the termination payment (buyout) at the time a contractual commitment has been made.

4.3.10.1.1

Fair value considerations (ASC 820)

In most situations, there will not be a significant amount of time between a contractual contract termination and the payment of the termination fee. As a result, the effects of a fair value measurement on most contract termination costs generally will not be significant. When the payment of a contractual termination fee follows shortly after notifying the counterparty, or concluding negotiations with the counterparty, the effect of discounting at a credit-adjusted risk-free rate will likely not be significant. Further, both the amount and timing of the payment in such a case is generally certain, so a market risk premium should not have a significant effect. A market risk premium is designed to compensate for uncertainty as to the amount and timing of cash flows. The fair value of the liability should consider an

adjustment for non-performance risk and a profit margin demanded by a third party, if significant. See our Fair value measurements and disclosures FRD for further discussion on determining fair value pursuant to the framework in ASC 820.

4.3.10.2

Costs that will continue to be incurred under a contract

Excerpt from Accounting Standards Codification

Leases – Overall

Relationships

840-10-60-6

For costs that will continue to be incurred under a lease for its remaining term without economic benefit to the entity, see paragraph 420-10-25-13.

Exit or Disposal Cost Obligations – Overall

Recognition

420-10-25-13

A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be recognized at the cease-use date. For an illustration of this situation, see Example 4 (paragraph 420-10-55-11).

Initial Measurement

420-10-30-8

If the contract is an operating lease, the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals, adjusted for the effects of any prepaid or deferred items recognized under the lease, and reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease. Remaining lease rentals shall not be reduced to an amount less than zero.

420-10-30-9

A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be measured at its fair value at the cease-use date. For an illustration of this situation, see Example 4 (paragraph 420-10-55-11).

4.3.10.2.1

Cease-use date

A liability for costs that will continue to be incurred under a lease for its remaining term without economic benefit to the entity should be recognized and measured at its fair value when the entity ceases using the right conveyed by the lease. This approach is referred to as a “cease-use date approach”. We believe that a “cease-use date” exists only when an entity has completely vacated the space (that is, the space cannot be used for any other purpose including storage). Additionally, the space must be available space so that it can be subleased if and when a tenant becomes available. For example, it should be possible for the future tenants to be able to enter the space from a common area (e.g., a separate room, a floor with a separate door, a separate floor with access from the main entrance). The intent is that the space is separate and distinct from the lessor’s other space, if any. Consider the following example.

Illustration 4-15: Determining the cease-use date

On 15 January 20X9 (5 years prior to the end of the lease term), Lessee B commits to a plan to exit a facility that is leased under an operating lease. Under the plan, the lessee expects to vacate the facility no later than 31 July 20X9. On 15 June 20X9, Lessee B ceases using the facility (i.e., the space has been completely vacated). Accordingly, any loss measured pursuant to ASC 420 would be recorded on 15 June 20X9 (the “cease-use date”).

4.3.10.3**Initial measurement**

The fair value of a liability for a lease termination under a cease-use date approach is the present value of the contractual obligation adjusted for valuation assumptions (e.g., market risk premium and/or profit margin) that reflect the amount a market participant would require to assume the obligation at the measurement date. In valuing a lease under the cease-use date approach, the fair value of the obligation should be determined based on the remaining lease rentals, adjusted for the effects of any prepaid or deferred items recognized, reduced by estimated sublease rentals that could be reasonably obtained, even if the entity does not intend to sublease (so long as it is contractually permitted).

While “remaining lease rentals” as discussed in ASC 420-10-30-8 is not defined in existing literature, ASC 420-10-30-9 states “A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be measured at its fair value at the cease-use date.” Therefore, if executory costs (e.g., common area maintenance costs, real estate taxes) are required to be paid by the lessee as part of the lease contract, those costs will continue to be incurred by the lessee and should be included in any calculation of contract termination costs.

The measurement of any net liability would be a discounted amount that includes the nonperformance risk associated with the liability and an appropriate market risk premium. The effect, if any, of the market risk premium, will be relative to the uncertainty in the timing and amount of the future cash flows. Although the contractual lease payments are fixed with respect to both timing and amount, sublease income, if any, can fluctuate as to the timing of when a tenant would sublease and the amount of rent that would be paid. An operating lease example is included in ASC 420-10-55-11 through 55-15 and it excludes a market risk premium. The example notes that a market risk premium was excluded as follows:

“Because the lease rentals are fixed by contract and the estimated sublease rentals are based on market prices for similar leased property for other entities having similar credit standing as the entity, there is little uncertainty in the amount and timing of the expected cash flows used in estimating fair value at the cease-use date and any risk premium would be insignificant. In other circumstances, a risk premium would be appropriate if it is significant.”

We believe the key point in this example is likely the final sentence. That is, an entity will have to determine whether a market risk premium would be significant rather than simply excluding it.

4.3.10.3.1***Effect of subleasing on measurement***

An estimate of sublease rental income should be included in the determination of fair value. Because the objective of the measurement is the fair value of the liability, a lessee’s intention to not sublease (e.g., for competitive or other reasons) is not a factor in determining fair value. However, only sublease rentals that can be reasonably obtained should be included. For example, estimated sublease rentals should not be included in determining fair value if the lease agreement prohibits subleasing.

In certain instances it may not be reasonable for a lessee to sublease property or it may take time to enter into a sublease. This evaluation is based on facts and circumstances and, as noted in the prior paragraph, is not affected by the lessee's intent. For example, the lessee may have only a few months left on its lease such that it would not be reasonable for a third party to enter into a sublease. Accordingly, in this situation, reasonably obtainable sublease income may be \$0.

We believe sublease rentals that could be reasonably obtained generally should be assumed to occur under a lease that is identical in structure to the original lease (e.g., gross lease, net lease). If the original lease is a triple net lease, the fair value of the liability at the cease-use date generally should be determined based on the remaining lease rentals, reduced by estimated sublease rentals that could be reasonably obtained under a triple net lease.

4.3.10.4 Temporarily cease-use

One of the key issues in applying the accounting provisions for exit or disposal cost obligations to lease arrangements is whether a decision to temporarily cease to use a leased facility would be subject to the provisions of ASC 420. We believe that an evaluation of whether an entity has ceased to use a facility temporarily or permanently is a facts-and-circumstances based evaluation; however, to the extent the cessation is temporary (e.g., a company vacates a leased office building for an anticipated one-year period as part of a restructuring where departments are located and intends to have departments relocated to that facility within a year) such temporary vacancy would not be subject to ASC 420. Noteworthy, however, is that the FASB did indicate that an entity ceasing to use property in their view generally would provide evidence that the entity will not use the property for the remaining lease term. See Section 4.3.10.6 regarding the interaction of the guidance for accounting for contract termination costs and the guidance for accounting for losses on subleases and Section 12.3.3 for additional information on accounting for losses on subleases.

4.3.10.5 Subsequent measurement

For the subsequent measurement of lease termination costs, the same rules apply as for other costs associated with an exit or disposal activity. That is, changes to the liability as a result of the timing and amount of estimated cash flows should be measured using the credit-adjusted, risk-free rate that was used to measure the liability initially with a resulting adjustment to be recorded in the period of change (i.e., the subsequent measurement of a restructuring liability is not a fair value measurement). An example would be a property under an operating lease that an entity ceases to use and expects to obtain certain market-based sublease income. In this case, the entity would record a liability (expense) for the future lease rentals at the cease-use date (reduced by reasonably obtainable sublease rentals, if any) and adjust the amount of the liability based on sublease market changes prior to entering into a sublease and to actual sublease income if a sublease has been entered into. The following example illustrates the application of the accounting provisions for contract termination costs.

Excerpt from Accounting Standards Codification

Exit or Disposal Cost Obligations – Overall

Implementation Guidance and Illustrations

420-10-55-11

This Example illustrates the guidance in paragraphs 420-10-25-11 through 25-13 and paragraphs 420-10-30-7 through 30-9 related to terminating an operating lease at the cease-use date and after the cease-use date.

420-10-55-12

An entity leases a facility under an operating lease that requires the entity to pay lease rentals of \$100,000 per year for 10 years. After using the facility for five years, the entity commits to an exit plan. In connection with that plan, the entity will cease using the facility in 1 year (after using the facility for 6 years), at which time the remaining lease rentals will be \$400,000 (\$100,000 per year for the remaining term of 4 years). In accordance with paragraphs 420-10-30-7 through 30-9, a liability for the remaining lease rentals, reduced by actual (or estimated) sublease rentals, would be recognized and measured at its fair value at the cease-use date (as illustrated following paragraph). In accordance with paragraphs 420-10-35-1 through 35-4, the liability would be adjusted for changes, if any, resulting from revisions to estimated cash flows after the cease-use date, measured using the credit-adjusted, risk-free rate that was used to measure the liability initially (as illustrated in paragraph 420-10-55-15).

420-10-55-13

Based on market rentals for similar leased property, the entity determines that if it desired, it could sublease the facility and receive sublease rentals of \$300,000 (\$75,000 per year for the remaining lease term of 4 years). However, for competitive reasons, the entity decides not to sublease the facility (or otherwise terminate the lease) at the cease-use date. The fair value of the liability at the cease-use date is \$89,427, estimated using an expected present value technique. The expected net cash flows of \$100,000 (\$25,000 per year for the remaining lease term of 4 years) are discounted using a credit-adjusted, risk-free rate of 8 percent. In this case, a risk premium is not considered in the present value measurement. Because the lease rentals are fixed by contract and the estimated sublease rentals are based on market prices for similar leased property for other entities having similar credit standing as the entity, there is little uncertainty in the amount and timing of the expected cash flows used in estimating fair value at the cease-use date and any risk premium would be insignificant. In other circumstances, a risk premium would be appropriate if it is significant. Thus, a liability (expense) of \$89,427 would be recognized at the cease-use date.

420-10-55-14

Accretion expense would be recognized after the cease-use date in accordance with the guidance beginning in paragraph 420-10-35-1 and in paragraph 420-10-45-5. (The entity will recognize the impact of deciding not to sublease the property over the period the property is not subleased. For example, in the first year after the cease-use date, an expense of \$75,000 would be recognized as the impact of not subleasing the property, which reflects the annual lease payment of \$100,000 net of the liability extinguishment of \$25,000).

420-10-55-15

At the end of one year, the competitive factors referred to above are no longer present. The entity decides to sublease the facility and enters into a sublease. The entity will receive sublease rentals of \$250,000 (\$83,333 per year for the remaining lease term of 3 years), negotiated based on market rentals for similar leased property at the sublease date. The entity adjusts the carrying amount of the liability at the sublease date to \$46,388 to reflect the revised expected net cash flows of \$50,000 (\$16,667 per year for the remaining lease term of 3 years), which are discounted at the credit-adjusted, risk-free rate that was used to measure the liability initially (8 percent). Accretion expense would be recognized after the sublease date in accordance with the guidance beginning in paragraph 420-10-35-1 and in paragraph 420-10-45-5.

4.3.10.6**Interaction with accounting for a loss on a sublease**

Accounting for a loss on a sublease of an operating lease is addressed in 840-20-25-15 (see Section 12.3). See Section 12.3.3 for additional information on accounting for a loss on a sublease under ASC 840-20-25-15.

4.3.11 Sale by lessee of an interest in an operating lease

Any gain on sale of a component of an operating lease (e.g., sale of the purchase option or renewal term) should be deferred and recognized over the remaining term of the operating lease. Any loss on sale should be recognized immediately.

4.4 Lessee accounting for maintenance deposits

Excerpt from Accounting Standards Codification

Leases – Overall

Overview and Background

840-10-05-9A

Under certain equipment lease agreements, a lessee is legally or contractually responsible for repair and maintenance of the leased asset throughout the lease term. Additionally, certain lease agreements include provisions requiring the lessee to make deposits to the lessor to financially protect the lessor in the event the lessee does not properly maintain the leased asset. Lease agreements often refer to these deposits as maintenance reserves or supplemental rent. However, the lessor is required to reimburse the deposits to the lessee upon the completion of maintenance activities that the lessee is contractually required to perform under the lease agreement.

840-10-05-9B

Under a typical arrangement, maintenance deposits are calculated based on a performance measure, such as hours of use of the leased asset, and are contractually required under the terms of the lease agreement to be used to reimburse the lessee for required maintenance of the leased asset upon the completion of that maintenance. The lessor is contractually required to reimburse the lessee for the maintenance costs paid by the lessee, to the extent of the amounts on deposit.

840-10-05-9C

In some cases, the total cost of cumulative maintenance events over the term of the lease is less than the cumulative deposits, resulting in excess amounts on deposit at the expiration of the lease. In those cases, some lease agreements provide that the lessor is entitled to retain such excess amounts; whereas other agreements specifically provide that, at the expiration of the lease agreement, such excess amounts are returned to the lessee (refundable maintenance deposit). Paragraph 840-10-25-39A provides related guidance.

Recognition

840-10-25-39A

The guidance in the following paragraph and paragraph 840-10-35-9A does not apply to payments to a lessor that are not substantively and contractually related to maintenance of the leased asset. If at lease inception a lessee determines that it is less than probable that the total amount of payments will be returned to the lessee as a reimbursement for maintenance activities, the lessee shall consider that when determining the portion of each payment that is not addressed by the guidance in the following paragraph and paragraph 840-10-35-9A.

840-10-25-39B

Maintenance deposits paid by a lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities shall be accounted for as a deposit asset. Paragraph 840-10-35-9A provides guidance on subsequent measurement of deposit assets.

Subsequent Measurement

840-10-35-9A

A lessee shall evaluate whether it is probable that an amount on deposit recognized under paragraph 840-10-25-39B will be returned to reimburse the costs of the maintenance activities incurred by the lessee. When an amount on deposit is less than probable of being returned, it shall be recognized as additional expense. When the underlying maintenance is performed, the maintenance costs shall be expensed or capitalized in accordance with the lessee's maintenance accounting policy.

Under certain lease arrangements, a lessee may be contractually or legally responsible for repair and maintenance of the leased asset during the term of the lease arrangement. In addition, the lease arrangement may require the lessee to make deposits (also commonly referred to as maintenance reserves or supplemental rent) with the lessor to protect the lessor if the lessee does not properly maintain the leased asset (i.e., the lessor would use the funds to restore the leased asset to proper working order). Under a typical lease arrangement, the lessor is contractually required to reimburse the lessee a portion of the deposit as qualifying maintenance activities are performed and paid for by the lessee. If the deposits paid to the lessor exceed costs incurred for maintenance activities, certain lease arrangements state that the lessor is entitled to retain such excess amounts at the expiration of the lease arrangements, whereas other lease arrangements require the lessor to refund such excess amounts to the lessee. While refundable maintenance deposits are accounted for by lessees as a deposit, some had questioned the accounting for lessee maintenance deposits that are not automatically refundable in all instances, including those that are not refunded if the lessee does not perform the maintenance activities specified by the lease arrangement. Questions have arisen regarding the accounting for such maintenance deposits by lessees.

Maintenance deposits paid by the lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities should be considered deposit assets by the lessee if it is probable that the deposits will be refunded. The cost of maintenance activities should be expensed or capitalized by the lessee, as appropriate, when the underlying maintenance is performed. If it is determined that a maintenance deposit is less than probable of being refunded to the lessee, the deposit is recognized as additional rent expense. If it is probable at inception of the lease that a portion of the deposits will not be refunded, the lessee should recognize as expense a pro-rata portion of the deposits as they are paid.

Some lease agreements call for maintenance deposits and refunds to be made throughout the term of the lease. For instance, an airplane lease may require the lessee to make a deposit with the lessor based on usage of the airplane (e.g., pay a defined amount for every hour or cycle flown) and the lessor to refund those deposits upon the performance of required maintenance activities. In such leases, deposits can be made and refunded multiple times over the lease. The following illustration depicts the accounting treatment for multiple cycle maintenance deposits.

Illustration 4-16: Deposits in leases with multiple maintenance cycles

Airline A leases an airplane from Lessor B for 10 years and agrees to provide Lessor B with maintenance deposits of \$50 for every flight hour flown. Airline A is responsible for maintaining the airplane and Lessor B must reimburse Airline A for engine overhaul maintenance costs incurred up to the extent of the amounts on deposit when the engine overhaul maintenance occurs. Any excess amounts on deposit are retained by Lessor B.

Assume that the airplane being leased requires engine overhaul maintenance to be performed after every 20,000 flight hours and the expected cost of the engine overall maintenance exceeds the amounts to be placed on deposit (i.e., expected cost of engine overhaul is greater than \$1,000,000 = \$50/hour x 20,000 hours). Airline A expects to fly the leased airplane between 4,000 and 5,000 hours each year.

In the early periods under the lease, deposits made by Airline A are probable of being returned as Airline A expects to incur reimbursable maintenance costs by performing engine overhaul maintenance. As such, maintenance deposits made should be accounted for as deposit assets.

Towards the end of the lease, Airline A may be required to make maintenance deposits that are not probable of being returned to the extent that Airline A does not expect to perform another engine overhaul. For instance, assume Airline A flies the airplane for a total of 40,000 hours over the first nine years of the lease, performs the second engine overhaul at the end of the ninth year and receives reimbursement from Lessor B for the funds on deposit. Airline A would still be required to make payments of \$50 for every flight hour flown in the 10th year of the lease; however, as Airline A will not perform another engine overhaul, those payments will not be returned. As such, the maintenance deposit payments made by Airline A subsequent to the second engine overhaul would not be considered deposit assets (as they are less than probable of being returned to Airline A) and should be accounted for as contingent rent.

For purposes of the determination of whether it is probable that the deposit will be refunded, the definition of probable in CON 6 is applicable. Pursuant to CON 6, "Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in paragraph 3 of Statement 5), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved." We believe that this approximates a more-likely-than-not probability threshold which is a lower threshold of probability than is used in ASC 450, *Contingencies*, with respect to the recognition of liabilities.

4.5

Disclosures

Excerpt from Accounting Standards Codification

Leases – Overall

Disclosures

840-10-50-2

The lessee shall disclose, in its financial statements or footnotes thereto, a general description of its leasing arrangements including, but not limited to, all of the following:

- a. The basis on which contingent rental payments are determined.
- b. The existence and terms of renewal or purchase options and escalation clauses.
- c. Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

840-10-50-3

See paragraph 460-10-50-4 for required disclosures of guarantees.

Leases – Operating Leases

Disclosures

840-20-50-1

For all operating leases, the lessee shall disclose 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.

840-20-50-2

For operating leases having initial or remaining noncancelable lease terms in excess of one year, the lessee shall disclose both of the following:

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

840-20-50-3

Example 1 (see paragraph 840-10-55-40) illustrates a lessee's application of the disclosure requirements of Subtopic 840-10 for an operating lease.

Leases – Capital Leases***Disclosures*****840-30-50-1**

All of the following information with respect to capital leases shall be disclosed in the lessee's financial statements or the footnotes thereto:

- a. 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.
- b. 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 paragraphs 840-30-30-1 through 30-4).
- c. 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.
- d. Total contingent rentals actually incurred for each period for which an income statement is presented.

840-30-50-2

If the information required by paragraph 840-30-45-3 is not separately disclosed by the lessee in the financial statements, it shall be disclosed in the footnotes thereto.

840-30-50-3

Example 1 (see paragraph 840-10-55-40) illustrates certain disclosures.

5 Lessor accounting

This Section addresses lessor accounting, while the previous section, Section 4, addresses lessee accounting. Section 3 describes the criteria used to classify leases including the additional classification criteria applicable to lessors (see Section 3.3) and Section 6 describes additional classification criteria for leases of real estate. Lessors must classify each of their leases as one of the following:

- ▶ Sales-type – Sales-type leases give rise to a 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 (see Section 2.2) is greater or less than its carrying amount) and normally result when a company uses leasing as a means of marketing its products (ASC 840-10-25-43(a) – see Section 3.3).
- ▶ Direct financing – Direct financing leases do not give rise to manufacturer’s or dealer’s profit or loss to the lessor and result from financing the acquisition of property by a lessee (ASC 840-10-25-43(b) – see Section 3.3).
- ▶ Leveraged – Leveraged leases, which are discussed in Section 14, meet all the criteria of a direct financing lease plus certain other specified criteria.
- ▶ Operating – Operating leases are all leases not classified as sales-type, direct financing or leveraged leases.

5.1 Sales-type leases other than real estate

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Recognition

840-30-25-3

Contingent rentals on a sales-type lease or direct financing lease shall be included by the lessor in the determination of income as accruable.

840-30-25-5

If a sales-type lease involves real estate, the lessor shall account for the transaction under the guidance in Subtopic 360-20 in the same manner as a seller of the same property.

840-30-25-6

The lessor in a sales-type lease that does not involve real estate shall recognize its gross investment in the lease, unearned income, and the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs minus the present value of the unguaranteed residual value accruing to the benefit of the lessor, shall be charged against income in the same period.

Initial Measurement

840-30-30-6

The lessor shall measure the gross investment in either a sales-type lease or direct financing lease initially as the sum of the following amounts:

- 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) including any profit thereon

- b. The unguaranteed residual value accruing to the benefit of the lessor. The estimated residual value used to compute this amount shall not exceed the amount estimated at lease inception except as provided in paragraph 840-30-30-7.

840-30-30-7

If a lease agreement (or commitment, if earlier) includes a provision to escalate minimum lease payments either for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value (such as general price levels) during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of the estimated residual value of the leased property at lease inception for purposes of applying the guidance in paragraphs 840-30-30-6(b) and 840-30-30-14(c).

840-30-30-8

The lessor's net investment in a sales-type lease shall consist of the gross investment (as measured in paragraph 840-30-30-6) minus the unearned income.

840-30-30-9

The lessor shall measure unearned income initially as the difference between the gross investment in the sales-type lease and the sum of the present values of the two components of the gross investment. The discount rate to be used in determining the present values shall be the interest rate implicit in the sales-type lease.

840-30-30-10

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 by the lessor as the sales price.

Subsequent Measurement

840-30-35-22

A lessor shall amortize the unearned income on a sales-type lease to income over the lease term to produce a constant periodic rate of return on the net investment in the lease (the interest method). In a sales-type lease containing a residual guarantee or a termination penalty for failure to renew the lease at the end of the lease term, this method of amortization described will result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the residual value guarantee or termination penalty at that date.

840-30-35-23

The lessor shall amortize the unearned income and initial direct costs on a direct financing lease to income over the lease term to produce a constant periodic rate of return on the net investment in the lease. A residual value guarantee or termination penalty that serves to extend the lease term is excluded from minimum lease payments and is thus distinguished from those residual value guarantees and termination penalties referred to in this paragraph. In the event that a renewal or other extension of the lease term (including a new lease under which the lessee continues to use the same property) renders the residual value guarantee or termination penalty in a sales-type lease or direct financing lease 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 paragraph 840-30-35-25) and the net adjustment shall be charged or credited to unearned income.

840-30-35-25

A lessor shall review the estimated residual value of a leased property at least annually. If the review results in a lower estimate than had been previously established, the lessor shall determine 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 and the resulting reduction in the net investment shall be recognized by the lessor as a loss in the period in which the estimate is changed. An upward adjustment of the leased property's estimated residual value (including any guaranteed portion) shall not be made.

Other Presentation Matters**840-30-45-4**

The net investment in a sales-type or direct financing lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.

A sales-type lease is accounted for by recording the following:

1. Gross investment – The minimum lease payments – see Section 2.9 – (which exclude executory costs and any related profit) plus any unguaranteed residual value (see Section 2.8) accruing to the benefit of the lessor. No residual value is assumed to accrue to the benefit of the lessor if the lease either transfers ownership or contains a bargain purchase option. See Section 2.4 for further discussion regarding bargain purchase options.
2. Unearned income – The gross investment less the combined present values of the components of the gross investment.
3. Net investment – The gross investment less the unearned income.
4. Sales price – The present value of the minimum lease payments (see Section 2.9).
5. Cost of sales – The cost or carrying amount, if different, of the leased property less the present value of any unguaranteed residual value (see Section 2.8) accruing to the benefit of the lessor. If a portion of the minimum lease payments (see Section 2.9) is attributable to such items as delivery costs or sales taxes incurred, those items should be accounted for as part of the cost or carrying amount of the leased property.
6. Expenses – Any initial direct costs (see Section 2.12).

Unearned income should be amortized over the lease term (see Section 2.6) using the interest method. The amortization method applied should result in a remaining net investment balance at the end of the lease term equal to the amount of any (1) bargain purchase option, (2) residual guarantee, (3) termination penalty (see Section 2.14), provided that the lease term does not include any renewal periods reasonably assured because of the penalty, and/or (4) any unguaranteed residual value. See Section 2.13.3 for discussion of lessor accounting for contingent rent.

The net investment should be presented on the balance sheet as an investment in the lease and is subject to the same considerations as other assets in classification as current or noncurrent.

5.1.1 Sales-type lease – comprehensive example

Illustration 5-1: Accounting for sales-type leases

ABC Company manufactures equipment with an estimated economic life of 12 years and leases it to XYZ Company for a period of 10 years. The normal selling price is \$144,128, and the unguaranteed residual value at the end of the lease term is estimated to be \$10,000. XYZ Company will pay annual rentals of \$20,000 at the beginning of each year and is responsible for all maintenance, insurance, and taxes. ABC Company incurred costs of \$100,000 in manufacturing the equipment and \$2,000 in negotiating and closing the lease. It has been determined that the collectibility of payments is reasonably predictable and there will be no additional costs incurred. The implicit interest rate is 9%.

The lease meets the criteria for classification as a sales-type lease because (1) the lease term exceeds 75% of the equipment's estimated economic life, (2) collectibility of payments is reasonably assured and there are no further costs to be incurred and (3) an element of profit is realized because the cost of the leased property differs from its fair value. This lease also satisfies the 90% of fair value test.

The information necessary to record the lease is as follows:

1. Gross investment is \$210,000 (10 annual lease payments of \$20,000 each plus the unguaranteed residual value of \$10,000).
2. Unearned income is \$65,872 (gross investment of \$210,000 less \$144,128, the present values of the components thereof – see computation below).
3. Net investment is \$144,128.
4. Sales price is \$139,904 (present value of the 10 annual rental payments – see computation below).
5. Cost of sales is \$95,776 (\$100,000 cost of the equipment less \$4,224, the present value of the unguaranteed residual value —see computation below).
6. Expenses are \$2,000 (initial direct costs).

The journal entries to account for this lease during the first year are as follows:

To record sale of property and net investment in sales-type leases:

Net investment – current portion	\$	8,828	
Net investment – long-term portion		135,300	
Cost of sales		95,776	
Selling expense		2,000	
Sales			\$ 139,904
Property held for lease			100,000
Cash			2,000

To record first year's lease payment and income earned on sales-type lease:

Cash	\$	20,000	
Net investment in sales-type leases			\$ 8,828
Interest income			11,172

The following shows the computation of the sales price and the present values of the components of the gross investment:

Sales price	
Factor for present value of \$1 payable in 9 annual payments (9% compounded annually)	5.9952
Initial payment (no interest element)	<u>1.0000</u>
	6.9952
Annual rental	X \$ 20,000
Sales value	<u>\$ 139,904</u>
Present value of residual	
Factor for present value of \$1 due in 10 years (9% compounded annually)	0.4224
Unguaranteed residual	X \$ 10,000
Present value of unguaranteed residual value	<u>4,224</u>
Present value of the gross investment components	<u>\$ 144,128</u>

The following table summarizes the amortization of the net investment and the recognition of the unearned income over the lease term:

Year	Annual rental payments	Annual interest income ¹	Net investment at end of year
Initial present value	\$ -	\$ -	\$ 144,128
1	20,000	11,172	135,300
2	20,000	10,377	125,677
3	20,000	9,511	115,188
4	20,000	8,567	103,755
5	20,000	7,538	91,293
6	20,000	6,417	77,710
7	20,000	5,194	62,904
8	20,000	3,861	46,765
9	20,000	2,409	29,174
10	20,000	826	10,000 ²

¹ Interest income equals 9% of the net investment at the beginning of each year less \$20,000, the rental payment made at the beginning of the year.

² Estimated residual value of the equipment at the end of the lease term.

Sales-type lease – sales price and the interest rate implicit in the lease

ASC 840-30-30-10 states that the sales price recorded by the lessor in a sales-type lease is “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.” Section 2.10 provides a general discussion of the interest rate implicit in the lease and an illustrative example of how to calculate such rate.

The basis for conclusions for Statement 13 (paragraph 100 of Statement 13) explains that the FASB required the use of the interest rate implicit in the lease so that the sales price would be measured on a basis consistent with the known fair value of the leased asset. Consequently, any stated transaction price and interest rate identified in a contract are not inputs into the measurement of the sales price for the purpose of applying sales-type lease accounting (i.e., day one gain or loss and subsequent interest income). Rather, the fair value of the leased asset is the input used to determine the interest rate implicit in the lease. Such rate in turn is used to measure the day one gain and subsequent interest income. The value of the leased asset is generally the amount at which a lessor would sell (as opposed to lease) the asset, net of any normal volume or trade discounts provided to similar customers that purchase the asset. Also refer to Sections 2.3 and 2.3.3 for a discussion of estimating fair value of leased assets.

The following illustrates the computation of the interest rate implicit in a sales-type lease including which inputs are relevant to how that rate affects the determination of the sales price recorded by the lessor.

Illustration 5-2: Determining the implicit interest rate and sales price for a sales-type lease

Company H is a manufacturer that sells and leases equipment. The equipment has a carrying amount (i.e., manufacturing cost) of \$100,000 and an economic life of 11 years. The residual value of the equipment is expected to be \$10,000 at the end of the Company's customary 10-year lease. The list price for the equipment is \$160,142. Company H provides an average discount of 10% off the list price to customers that buy the equipment without financing or special discounts. That is, the Company's cash selling price is \$144,128 and virtually all cash sales over the past 12 months have been at that price.

Company H offers the following options to Customer W:

- ▶ Customer W may purchase the equipment for \$147,000 cash.
- ▶ Customer W may lease the equipment for 10 years for \$20,000 per year (due at the beginning of each year) at a contractually stated interest rate of 7.6% (ten \$20,000 payments with an interest rate of 7.6% approximates the \$147,000 offered cash selling price).

Customer W agrees to lease the equipment at the terms stated above.

The lease meets the criteria for classification as a sales-type lease because (1) the lease term exceeds 75% of the equipment's estimated economic life, (2) collectibility of payments is determined to be reasonably predictable and there are no uncertainties about the costs yet to be incurred by Company H and (3) the lease will give rise to manufacturer profit (i.e., because the cost of the equipment differs from its fair value).

Importantly the following are not relevant inputs to the calculation of the interest rate implicit in the lease:

- ▶ The list price, \$160,142
- ▶ The offered cash purchase price, \$147,000
- ▶ The contractually stated interest rate, 7.6%

Rather, the calculation of the interest rate implicit in the lease requires use of the fair value of the leased equipment at lease inception, which is generally the normal selling price of the equipment, reflective of any volume or trade discounts that may apply. Therefore, in this circumstance the equipment's fair value would be \$144,128 (\$160,142 list price - 10% normal discount of \$16,014).

Therefore, Company H calculates the interest rate implicit in the lease as 9.0% (compounded annually).

The 9.0% rate is the discount rate that causes the aggregate present value of the minimum lease payments (\$139,904) and the present value of the unguaranteed residual value (\$4,224) to equal the equipment's fair value (\$144,128) at lease inception. The following table shows the computation of the present values of the minimum lease payments (i.e., the sales price) and the unguaranteed residual value using the interest rate implicit in the lease:

Sales price

Factor for present value of \$1 payable in 9 annual payments (9.0% compounded annually)	5.9952	
Initial payment (no interest element)	<u>1.0000</u>	
	6.9952	
Annual rental	X \$ <u>20,000</u>	
Present value of minimum lease payments (sales price)		\$ 139,904

Present value of residual

Factor for present value of \$1 due in 10 years (9.0% compounded annually)	0.4224	
Unguaranteed residual	X \$ <u>10,000</u>	
Present value of unguaranteed residual value		<u>4,224</u>

Fair value of leased asset (normal selling price) \$ 144,128

Company H records a sales price of \$139,904 for the sales-type lease. The present value of the unguaranteed residual value is included in Company H's net investment in the lease (see Section 5.1). The information necessary to record the sales-type lease is as follows:

1. Gross investment is \$210,000 (10 annual lease payments of \$20,000 each plus the unguaranteed residual value of \$10,000).
2. Unearned income is \$65,872 (gross investment of \$210,000 less \$144,128, the present values of the components thereof – see computation above).
3. Net investment is \$144,128.
4. Sales price is \$139,904 (present value of the 10 annual rental payments – see computation above).
5. Cost of sales is \$95,776 (\$100,000 cost of the equipment less \$4,224, the present value of the unguaranteed residual value – see computation above).

The journal entry to account for this lease at commencement are as follows:

To record sale of property and net investment in sales-type lease:

Net investment – current portion	\$ 8,828	
Net investment – long-term portion	135,300	
Cost of sales	95,776	
Sales		\$ 139,904
Property held for lease		100,000

5.1.2**Accounting for future costs in a sales-type lease, including warranties**

The estimated costs associated with a warranty or ongoing commitment that is incurred in conjunction with a sales-type lease should be recorded at the time of the sale. This accounting is based on the accounting for initial direct costs. The FASB noted in the basis for conclusions for Statement 13 that the accounting for initial direct costs follows APB 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 (paragraph 101 of Statement 13).

Warranty obligations are contingencies because of the uncertainty surrounding future claims. An accrual for warranty obligations is required if it is probable that customers will make valid warranty claims and the aggregate amount of the claims can be reasonably estimated. A reasonable estimate may be based on individual or overall claims and usually will depend on the enterprise's warranty experience.

In estimating amounts of warranty obligations, it may be appropriate for an enterprise to consider other factors in addition to warranty experience. For example, estimates of warranty obligations for a new product could be based on engineering studies or other data and may result in an estimated amount that is relatively high or relatively low compared with amounts based on warranty experience for existing products. When estimating amounts of product warranty obligations, an enterprise should consider the impact of trends in consumer legislation and regulations. Inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims precludes accrual and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded prior to the expiration of the warranty period or until sufficient experience has been gained to permit a reasonable estimate of the obligation.

An extended warranty contract is an agreement to provide warranty protection in addition to the scope of the manufacturer's original warranty, if any, or to extend the period of coverage provided by the manufacturer's original warranty. A product maintenance contract is an agreement to perform certain agreed-upon services to maintain a product for a specified period of time. The terms of the contract may take different forms, such as an agreement to periodically perform a particular service a specified number of times over a specified period of time, or an agreement to perform a particular service as the need arises over the term of the contract. A contract is separately priced if the customer has the option to purchase the services provided under the contract for an expressly stated amount separate from the price of the product.

If in conjunction with entering into a sales-type lease the lessor and lessee also enter into a separate extended warranty agreement, the estimated portion of the extended warranty contract should be excluded from the lease payments and accounted for in accordance with the applicable guidance in ASC 605-20, *Revenue Recognition – Services*, as follows:

- ▶ Revenue from separately priced contracts is required to be deferred and recognized in income on a straight-line basis over the contract period. Cost of services performed under the contract should be charged to expense as incurred (ASC 605-20-25-3). Costs that are directly related to the acquisition of a contract are required to be deferred and charged to expense in proportion to the revenue recognized (ASC 605-20-25-4).
- ▶ ASC 605-20-25-5 through 25-6 discuss recognizing revenue when the service is not expected to be performed evenly over the contract life, expected losses from these contracts and other special circumstances related to these contracts.

5.1.3 Adjustments in residual value

A lessor is required to review residual values at least annually. If the estimated residual value is determined to be excessive and the decline in its value is judged to be other than temporary, the accounting, but not the lease's classification, should be revised using the new estimate. The resulting reduction in the net investment should be charged to operations in the period the estimate is changed. Upward adjustments are specifically prohibited, even if they result from renegotiations of the guaranteed residual values (ASC 840-30-35-25 – see Section 5.1).

5.1.4 Revision and termination of leases

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Recognition

840-10-25-51

A renewal or an extension of an existing sales-type or direct financing lease (including a new lease under which the lessee continues to use the same property) that otherwise qualifies as a sales-type lease shall be classified by the lessor as a direct financing lease unless the renewal or extension occurs at or near the end of the original term specified in the existing lease, in which circumstance it shall be classified by the lessor as a sales-type lease. (See paragraph 840-30-35-28.) 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.

840-10-25-52

When an existing sales-type or direct financing lease is renewed or extended during the term of the existing lease, if the carrying amount of the property at the end of the original lease term is different from its fair value at that date, that fact shall not preclude the classification of the renewal or extension as a direct financing lease. (See paragraph 840-30-35-30.)

Subsequent Measurement

840-30-35-26

Paragraph 840-10-35-4 provides overall guidance on lease modifications. This incremental guidance for the lessor in a sales-type or direct financing lease is organized as follows:

- a. Lease term renewals and extensions
- b. Other lease modifications.

Lease Term Renewals and Extensions

840-30-35-27

Paragraph 840-30-35-23 addresses a renewal or extension of the lease term (including a new lease under which the lessee continues to use the same property) that renders a residual value guarantee or termination penalty inoperative.

840-30-35-28

Except in that circumstance, a renewal or an extension of an existing lease (including a new lease under which the lessee continues to use the same property) shall be accounted for by the lessor as follows:

- a. If the renewal or extension is classified as a direct financing lease, it shall be accounted for as described in paragraph 840-30-35-30.
- b. If the renewal or extension is classified as an operating lease, the existing lease shall continue to be accounted for by the lessor as a sales-type or direct financing lease (as applicable) to the end of its original term, and the renewal or extension shall be accounted for as any other operating lease in accordance with the guidance in Subtopic 840-20.
- c. If a renewal or extension that occurs at or near the end of the term (including a renewal or extension that occurs in the last few months of an existing lease) is classified as a sales-type lease, the renewal or extension shall be accounted for as a sales-type lease.

*Other Lease Modifications***840-30-35-29**

Paragraph 840-30-35-31 addresses a change in the provisions of a direct financing 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.

840-30-35-30

Except in that circumstance, if the provisions of a sales-type or direct financing lease are changed in a way that changes the amount of the remaining minimum lease payments, 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 paragraph 840-30-35-25), and the net adjustment shall be charged or credited to unearned income if the change meets either of the following conditions:

- a. It does not give rise to a new agreement under the guidance in paragraph 840-10-35-4.
- b. It does give rise to a new agreement under the guidance in paragraph 840-10-35-4 but such agreement is classified by the lessor as a direct financing lease.

Derecognition**840-30-40-6**

If the change in the provisions of a lease that was classified as a sales-type, direct financing, or leveraged lease gives rise to a new agreement classified as an operating lease or if a supply arrangement (or a portion of a supply arrangement) ceases to be a lease due to a modification to the arrangement or other change, 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.

840-30-40-7

A termination of a 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 charging the net adjustment to income of the period.

An existing lease is considered a new agreement when it is renewed or extended beyond the original lease term (see Section 2.6). A new agreement also results when lease provisions (e.g., amount of rental payments) are changed in a manner that would have resulted in the lease being classified differently had the new terms been in effect at the original inception date (see Section 2.2). The exercise of a renewal option included as part of the original lease term (e.g., an option period for which exercise was reasonably assured because of a termination penalty) is not a renewal or extension of a lease. Changes in estimates (e.g., economic life or residual value) do not change the classification of a lease. In addition, to the extent a change in estimate related to a decrease in estimated residual value (see Sections 2.8 and Section 5.1.3) occurs, such decrease in residual value should be reflected prior to accounting for the new lease.

As discussed in Section 5.1.3, upward adjustments of estimated residual values are specifically prohibited, even if leases are revised (i.e., renewed, extended or otherwise changed).

5.1.4.1 **Classification of renewals or extensions of existing leases**

An existing lease is considered a new agreement when it is renewed or extended beyond the original lease term (see Section 2.6). See Section 5.1.4.1.1 for an exception when the renewal or other extension of the lease term renders a guarantee or penalty inoperative.

Renewal of a sales-type or direct financing lease with a sales-type lease

Statement 13, as originally issued, prohibited a renewal or extension of an existing sales-type or direct financing lease from being classified as a sales-type lease under the theory that the initial sales-type lease transferred substantially all of the economic value of the leased asset. Statement 13 was subsequently amended by Statement 27 to modify this prohibition. Under the modified guidance as codified in ASC 840, a lessor is required to classify a renewal or extension of a sales-type or direct financing lease as a sales-type lease if the lease would otherwise qualify as such and the renewal or extension occurs at or near the end of the lease term. Near the end of the lease term refers to the last few months of the existing lease term. The "second sale" would be recorded as of the beginning of the renewal or extension.

The prohibition of recording a renewal or extension of an existing sales-type or direct finance lease as a sales-type lease still applies if the renewal or extension occurs earlier than near the end of the lease term. This is consistent with the prohibition against recording an upward adjustment to the leased property's residual value. Similarly, the prohibition against classifying a lease as a sale-type lease continues to apply to the classification of a lease resulting from a change in the provisions of an existing lease or the accounting for changes in the provisions of a lease if those changes occur during the lease term.

This guidance applies to all lessors; therefore, financial institutions could have sales-type leases. For example, assume a bank leases an airplane under a direct financing lease, and at the expiration of the original term, the lease is renewed. If, at the inception of the renewed lease, the fair value of the leased property is greater or less than its carrying amount (which often will be the case) and the other classification criteria of 840-10-25-43(a) are met, the lease would be classified as a sales-type lease with recognition of the appropriate gain or loss.

Renewal of a sales-type or direct financing lease with a direct financing lease

When a sales-type or direct financing lease is renewed or extended and the new agreement is classified as a direct financing lease, the remaining balance of the minimum lease payments (see Section 2.9) and the estimated residual value (see Section 2.8), if affected, are adjusted. The net adjustment would be recorded as a charge or credit to unearned income.

Renewal of a sales-type or direct financing lease with an operating lease

If the new agreement is an operating lease as a result of a renewal or extension of a sales-type or direct financing lease, the original lease continues to be accounted for as a sales-type or direct financing lease to the end of its lease term. Thereafter, the renewal or extension would be accounted for as an operating lease.

5.1.4.1.1 *Renewal or other extension of the lease term renders the guarantee or penalty inoperative*

In the event that a renewal or other extension (not embedded in the original lease agreement) of the original lease term for a sales-type or direct financing lease renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value would be adjusted for the changes resulting from the revised agreement and the net adjustment would be charged or credited to unearned income.

5.1.4.2 Change in existing lease other than extending or renewing lease term

A change in a lease agreement other than to extend the lease term (e.g., a change in the amount of lease payments) requires a test to be performed to determine if a new lease has been created for accounting purposes. If it is determined that a new lease results, a second test is performed to determine the classification of the “new” lease. The tests are as follows:

1. The first test is performed to determine whether the classification of the existing lease at its inception would have been different had the new terms been in effect at inception. If, for example, the monthly rental under a 60-month lease is changed from \$1,000 a month to \$1,200 a month effective for the last 36 months, the lease would be tested using the criteria of ASC 840-10-25 (as of its inception date) as if it had required 24 monthly payments of \$1,000 and 36 payments of \$1,200. All other factors (interest rate, fair value and estimated residual value) used in this test of the lease would be the same as those used when the lease was classified initially. If, as a result of this test, it is determined that the revised lease terms would have resulted in a different classification of the lease, then the lease would be considered to be a new lease and the second test discussed below would be performed.
2. The second test is made as of the date of the change in lease terms and uses the revised terms of the lease over its remaining life. Factors such as the discount rate, fair value and estimated residual value would be based on current conditions as they exist at the date of change.

Sales-type or direct financing lease changed and a new lease does not result or the new lease is a direct financing lease

When a sales-type or direct financing lease is changed and the new agreement is classified as a direct financing lease, the remaining balance of the minimum lease payments (see Section 2.9) and the estimated residual value (see Section 2.8), if affected, are adjusted. The net adjustment is recorded as a charge or credit to unearned income. This same accounting is followed when a sales-type or direct financing lease is changed and the change does not result in a new agreement. As noted in Section 5.1.4.1, the requirement to classify a sales-type or direct financing lease as a sales-type lease if the lease would otherwise qualify as such and the renewal or extension occurs at or near the end of the lease term does not apply to changes other than renewals and extensions near the end of the lease term. Therefore, a change to an existing sales-type or direct financing lease, other than a renewal or an extension, that creates a new agreement cannot be classified as a sales-type lease.

Sales-type or direct financing lease changed and the new lease is an operating lease

When a new agreement is classified as an operating lease because of a change in the existing lease provisions, the remaining net investment in a sales-type or direct financing lease is eliminated. The leased property would be recorded as an asset subject to lease at the lower of its (1) original cost, (2) present fair value or (3) present carrying amount, with any net adjustment being charged to income.

5.1.4.3 Termination of an existing sales-type or direct financing lease

The termination of a sales-type or direct financing lease is accounted for by eliminating the net investment and recording the leased property as an asset at the lower of its (1) original cost, (2) present fair value or (3) present carrying amount, with any net adjustment being charged to income.

5.2 Direct financing leases other than real estate

Note that much of the guidance included in Section 5.1 applies to both sales-type and direct financing leases. For instance, ASC 840-30-30-6 through 30-7, ASC 840-30-35-22 through 35-30, ASC 840-30-40-6 through 40-7 and ASC 840-30-45-4 apply to direct financing leases as well as sale-type leases.

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Recognition

840-30-25-7

The lessor in a direct financing lease shall recognize its gross investment in the lease and unearned income.

Initial Measurement

840-30-30-11

The lessor's net investment in a direct financing lease shall consist of the gross investment (as measured in paragraph 840-30-30-6) plus any unamortized initial direct costs minus the unearned income.

840-30-30-12

Paragraph 310-20-15-1(b) states that paragraphs 310-20-25-2 through 25-3 and 310-20-35-2 through 35-3 and the definition of direct loan origination costs apply to lessors in determining the net amount of initial direct costs.

840-30-30-13

The difference between the gross investment in the direct financing lease and the cost or carrying amount, if different, of the leased property shall be recorded by the lessor as unearned income.

A direct financing lease is accounted for by recording the following:

1. Gross investment – The minimum lease payments (which exclude executory costs and any related profit – see Section 2.9) plus any unguaranteed residual value (see Section 2.8) accruing to the benefit of the lessor. No residual value is assumed to accrue to the benefit of the lessor if the lease either transfers ownership or contains a bargain purchase option. See Section 2.4 for further discussion regarding bargain purchase options.
2. Unearned income – The gross investment less the cost or carrying amount of the leased property. If a portion of the minimum lease payments is attributed to such items as delivery costs or sales tax incurred, those items should be accounted for as part of the cost or carrying amount of the leased property.
3. Initial direct costs (see Section 2.12) – Initial direct costs associated with direct financing leases are to be capitalized.
4. Net investment – The gross investment plus any unamortized initial direct costs less the unearned income.

Initial direct costs and the unearned income are amortized over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. Unearned income is amortized over the lease term using the interest method. See Section 2.6 for further discussion regarding lease term. The specified amortization method should result in a constant periodic rate of return on the net investment and in a remaining net investment balance at the end of the lease term equal to the amount of any (1) bargain purchase option, (2) residual guarantee, (3) termination penalty (see Section 2.14), provided the lease term does not include any renewal periods reasonably assured because of the penalty, and/or (4) any unguaranteed residual value. See Section 2.13.3 for discussion of lessor accounting for contingent rent.

5.2.1 Direct financing lease – comprehensive example

Illustration 5-3: Accounting for a direct financing lease

A company leases equipment with a cost and fair value of \$64,100 for a term of nine years at \$10,000 a year payable at the end of each year. The unguaranteed residual value at the end of the lease term is estimated to be \$5,260, and the estimated economic life is eleven years. The lessee pays all taxes, insurance and maintenance, and the company paid a \$1,000 broker's commission in connection with the transaction. Collectibility is reasonably assured, and there are no additional costs to be incurred by the company.

The lease meets the criteria for classification as a direct financing lease because (1) the lease term exceeds 75% of the equipment's estimated economic life, (2) collectibility is reasonably assured and there are no further costs to be incurred, and (3) there is no element of profit aside from the financing charge. This lease also satisfied the 90% of fair value test.

The information necessary to record the lease is as follows:

1. Gross investment is \$95,260 (9 annual lease payments of \$10,000 each plus the unguaranteed residual value of \$5,260).
2. Unearned income is \$31,160 (gross investment of \$95,260 less \$64,100, the cost of the equipment).
3. Initial direct costs broker's commission are \$1,000.
4. Net investment is \$65,100 (gross investment plus initial direct costs less unearned income).

The following table summarizes the income from this lease and the amortization of the net investment over the lease term:

Year	Annual rental payment	Annual interest income ¹	Net investment at end of year
Initial net investment	\$ -	\$ -	\$ 65,100
1	10,000	5,208	60,308
2	10,000	4,825	55,133
3	10,000	4,411	49,544
4	10,000	3,964	43,508
5	10,000	3,481	36,989
6	10,000	2,959	29,948
7	10,000	2,395	22,343
8	10,000	1,787	14,130
9	10,000	1,130	5,260 ²

¹ The rate for amortizing the unearned income and initial direct costs to produce a constant periodic rate of return on the remaining net investment is 8%. This can only be determined by trial and error or by using a computer program.

² This is the unguaranteed residual value at the end of the lease term.

The journal entries to account for this lease during the first year are as follows:

To record net investment in direct financing lease:

Net investment in direct financing leases	\$ 65,100	
Property		\$ 64,100
Cash		1,000

To record first year's lease payment and income earned on direct financing lease:

Cash	\$ 10,000	
Net investment in direct financing leases		\$ 4,792
Interest income		5,208

The following table shows the annual income from this direct financing lease as compared with the income that would be recognized if the lease was classified as an operating lease:

Year	Annual financing lease income	Annual operating lease income ³	Pretax income increase (decrease)
1	\$ 5,208	\$ 3,351	\$ 1,857
2	4,825	3,351	1,474
3	4,411	3,351	1,060
4	3,964	3,351	613
5	3,481	3,351	130
6	2,959	3,351	(392)
7	2,395	3,351	(956)
8	1,787	3,351	(1,564)
9	<u>1,130</u>	<u>3,352</u>	<u>(2,222)</u>
	<u>\$ 30,160</u>	<u>\$ 30,160</u>	<u>\$ —</u>

³ Lease revenues of \$10,000 less depreciation of \$6,538 $(\$64,100 - \$5,260) \div 9$ and amortization of \$111 $(\$1,000 \div 9)$.

5.2.2 Revision and termination of leases

An existing lease is considered a new agreement when it is renewed or extended beyond the original lease term (see Section 2.6). A new agreement also results when lease provisions (e.g., amount of rental payments) are changed in a manner that would have resulted in the lease being classified differently had the new terms been in effect at the original inception date (see Section 2.2). The exercise of a renewal option included as part of the original lease term (e.g., an option period for which exercise was reasonably assured because of a termination penalty – see Section 2.14) is not a renewal or extension of a lease. Changes in estimates (e.g., economic life or residual value) do not change the classification of a lease. See Section 5.1.3 for additional discussion of adjustments in residual values. In addition, to the extent a change in estimate related to a decrease in estimated residual value occurs, such decrease in residual value should be reflected prior to accounting for the new lease. See Sections 5.1.4 – 5.1.4.3 for additional discussion of revisions and terminations of direct financing leases.

5.2.2.1

Lessor accounting for changes in lease provisions resulting from refundings of tax-exempt debt**Excerpt from Accounting Standards Codification****Leases – Capital Leases***Subsequent Measurement***840-30-35-31**

If, before the expiration of the lease term, a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt (including an advance refunding) in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a direct financing lease by the lessor, including governmental units that classify and account for leases of that kind, the change shall be accounted for as follows:

- a. If, in accordance with the guidance in Subtopic 470-50, that refunding is accounted for as an early extinguishment of debt, the lessor shall adjust the balance of the minimum lease payments receivable and the estimated residual value, if affected (that is, the gross investment in the lease) in accordance with the guidance in paragraphs 840-30-35-23 and 840-30-35-30. The adjustment of unearned income shall be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences shall be recognized as a gain or loss in the current period.
- b. If, in accordance with the guidance in Subtopic 470-50, that refunding is not accounted for as an early extinguishment of debt at the date of the advance refunding, the lessor shall systematically recognize, as revenue, any reimbursements to be received from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the period from the date of the advance refunding to the call date of the debt to be refunded.

Tax-exempt debt is often issued by a governmental or quasi-governmental authority to finance the construction of a facility such as a plant or a hospital. The user of the facility either buys the facility or leases it from the authority. The mortgage note or the lease serves as collateral for the tax-exempt debt and payments on the note or lease are the same, as to both amount and timing, as the debt service requirements of the tax-exempt debt. Often, in the case of a lease, title passes at the end of the lease term, thereby meeting one of the criteria for classification as a capital lease.

Many tax-exempt organizations have entered into a refunding by replacing the old debt with new debt to obtain an economic advantage (e.g., lower interest costs) for the lessee or mortgagor. As a result of the refunding, the terms of the related mortgage note or lease are changed to conform with the terms of the new debt issued.

Refunding of tax-exempt debt transactions are excluded from the requirements regarding changes in a lease agreement. Note that when developing the guidance excluding refundings of tax-exempt debt transactions, the FASB specifically elected not to cover refundings that do not involve tax-exempt debt (paragraph 9 of Statement 22). A lessor is required to account for refundings of tax-exempt debt transactions as follows.

ASC 840-30-35-31(a) provides guidance for advance refundings of tax-exempt debt that qualify as an early extinguishment of debt (ASC 405-20-40-1 provides criteria for determining when a liability has been considered extinguished). The lessor would adjust the balance of the gross investment in the lease to give effect to the revision in future rentals. In addition, the lessor would adjust unearned income in an amount required to increase or decrease the net investment in the lease (gross investment less unearned income) to the present value of the gross investment in the lease based on the interest rate applicable to the revised lease agreement. This combined adjustment gives rise to a gain or loss that is recognized in the current period. Thus, in most cases, the lessor will have a gain or loss from the early extinguishment of debt (pursuant to ASC 470-50, *Debt – Modifications and Extinguishments*) and a corresponding gain or loss from the change in the lease agreement.

ASC 840-30-35-31(b) provides guidance for advance refundings of tax-exempt debt which are not accounted for as early extinguishment of debt (i.e., the advance refunding does not qualify as an extinguishment of debt under ASC 405-20-40-1). If the lessee is obligated to reimburse the lessor for any costs related to the debt to be refunded that have been or will be incurred (e.g., unamortized discount, issue costs, call premium), the lessor shall systematically recognize the reimbursement as revenue, over the period from the date of the advance refunding to the call date of the debt to be refunded.

Below is an illustration of the accounting for a refunding transaction:

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Implementation Guidance and Illustrations

840-30-55-57

This Example illustrates a lessor's application of the guidance in paragraph 840-30-35-31 to a transaction meeting both of the following conditions:

- a. A refunding of tax-exempt debt results in a change in the provisions of a lease agreement.
- b. The revised lease is classified as a direct financing lease by the lessor.

840-30-55-58

The following table summarizes the total debt service requirements of the serial obligation to be refunded and of the refunding obligation. It is presumed that the perceived economic advantages of the refunding result from the lower interest rate applicable to the refunding obligation. The resulting reduction in total debt service requirements will be passed through to the lessee by changing the terms of the related lease to conform to the debt service requirements of the refunding obligation. All costs that have been or that will be incurred by the lessor in connection with the refunding transaction, will be passed through to the lessee.

Fifteen year serial debt service requirements (\$000 omitted):

Obligation to Be Refunded			Refunding obligation ^(a)			
Face amount	Interest 7%	Total	Face amount	Interest 5%	Total	Difference
\$ 50,000	\$ 32,300	\$ 82,300	\$ 52,000	\$ 23,150	\$ 75,150	\$ 7,150

^(a)The face amount of the refunding obligation (\$52,000,000) is equal to the sum of all of the following:

- a. The face amount of the obligation to be refunded (\$50,000,000)
- b. The redemption premium applicable to the obligation to be refunded (\$1,500,000)
- c. The costs of issuance (\$500,000).

840-30-55-59

The following tables illustrate computation of required adjustments to reflect changes in the terms of the lease resulting from the refunding of tax-exempt debt.

Adjustment to balance of minimum lease payments receivable:

Present balance of minimum lease payments receivable (equal to debt service requirements of obligation to be refunded)	\$ 82,300,000
Minimum lease payments receivable under revised agreement (equal to debt service requirements of refunding obligation)	<u>(75,150,000)</u>
Adjustment to reflect reduction in minimum lease payments receivable	<u>\$ 7,150,000</u>

Adjustment to unearned income:

Change in the sum of the present value of the two components of the gross investment using the interest rate applicable to each agreement	\$ 2,000,000
Change in the balance of minimum lease payments receivable	<u>7,150,000</u>
Adjustment to reflect reduction in balance of unearned income	<u>\$ 9,150,000</u>

Summary of adjustments (\$000 omitted):

	Minimum Lease Payments Receivable	Unearned Income	Net Investment
Balance before Refunding	\$ 82,300	\$ 32,300	\$ 50,000
Adjustment	<u>(7,150)</u>	<u>(9,150)</u>	<u>2,000</u>
Balance after refunding	<u>\$ 75,150</u>	<u>\$ 23,150</u>	<u>\$ 52,000</u>

840-30-55-60

The following tables illustrate the journal entries to record the refunding and changes in the terms of the lease resulting from refunding of tax-exempt debt.

Recoverable deferred issue costs	\$ 500,000	
Loss resulting from refunding of tax-exempt debt	1,500,000	
7% Outstanding obligation	50,000,000	
5% Refunding obligation		\$52,000,000
<i>To record loss from refunding \$50,000,000 – 7% obligation with \$52,000,000 – 5% refunding obligation in accordance with the guidance in Subtopic 470-50</i>		
Unearned income	\$ 9,150,000	
Minimum lease payments receivable		\$ 7,150,000
Gain resulting from adjustment of lease terms		1,500,000
Recoverable deferred issue costs		500,000
<i>To adjust unearned income by the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement in accordance with this Subtopic.</i>		

5.3

Operating leases**Excerpt from Accounting Standards Codification****Leases – Operating Leases****Recognition****840-20-25-1**

Rent shall be charged to expense by lessees (reported as income by lessors) over the lease term as it becomes payable (receivable). If the 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.

840-20-25-2

Certain operating lease agreements specify scheduled rent increases over the lease term that may, for example, be designed to provide an inducement or rent holiday for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements, or to acknowledge the time value of money. This Subtopic, however, differentiates between the following two items:

- a. Scheduled rent increases that are not dependent on future events. Such amounts are minimum lease payments to be accounted for under the preceding paragraph. Scheduled rent increases, which are included in minimum lease payments under Subtopic 840-10, shall be recognized by lessees and lessors on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money, anticipated inflation, or expected future revenues to allocate scheduled rent increases is inappropriate because these factors do not relate to the time pattern of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately.
- b. Contingent rentals. Increases or decreases in rentals that are dependent on future events such as future sales volume, future inflation, future property taxes, and so forth, are contingent rentals that affect the measure of expense or income as accruable, as specified by paragraph 840-10-25-4. If the lessee and lessor eliminate the risk of variable payments inherent in contingent rentals by agreeing to scheduled rent increases, the accounting shall reflect those different circumstances.

840-20-25-3

If rents escalate in contemplation of the lessee's physical use of the leased property, including equipment, but the lessee takes possession of or controls the physical use of the property at the beginning of the lease term, all rental payments by the lessee, including the escalated rents, shall be recognized as rental expense by the lessee (rental revenue by the lessor) on a straight-line basis in accordance with the preceding two paragraphs starting with the beginning of the lease term. This Subtopic considers the right to control the use of the leased property as the equivalent of physical use. If the lessee controls the use of the leased property, recognition of rental expense or rental revenue shall not be affected by the extent to which the lessee uses that property.

840-20-25-4

If rents escalate under a master lease agreement because the lessee gains access to and control over additional leased property at the time of the escalation, the escalated rents shall be considered rental expense by the lessee (rental revenue by the lessor) attributable to the leased property and recognized in proportion to the additional leased property in the years that the lessee has control over the use of the additional leased property.

840-20-25-5

The amount of rental expense (rental revenue) attributed to the additional leased property shall be proportionate to the relative fair value of the additional property, as determined at lease inception, in the applicable time periods during which the lessee controls its use.

840-20-25-6

Lease incentives shall be recognized as reductions of rental expense by the lessee (reductions in rental revenue by the lessor) on a straight-line basis over the term of the new lease in accordance with paragraphs 840-20-25-1 through 25-2.

840-20-25-7

Lease incentives include both of the following:

- a. Payments made to or on behalf of the lessee
- b. Losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party. In that circumstance, the new lessor and the lessee shall independently estimate any loss attributable to that assumption. For example, the lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption. The lessor shall estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed leased property. Example 1 (see paragraph 840-20-55-1) illustrates this guidance.

840-20-25-16

Initial direct costs shall be deferred by the lessor.

Subsequent Measurement**840-20-35-2**

Deferred initial direct costs shall be allocated by the lessor over the lease term in proportion to the recognition of rental income.

840-20-35-3

The property subject to an operating lease shall be depreciated following the lessor's normal depreciation policy. For guidance on lessor accounting for impairment of long-lived assets of lessors subject to operating leases, see the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10.

Other Presentation Matters**840-20-45-2**

The leased property shall be included by the lessor with or near property, plant, and equipment in the balance sheet.

840-20-45-3

Accumulated depreciation shall be deducted by the lessor from the investment in the leased property.

Leases that do not meet the criteria for a sales-type or direct financing leases are classified by the lessor as operating leases (ASC 840-10-25-43(d) – see Section 3.3).

When rental payments are not equal in amount over the term of an operating lease, rental income should be recognized using the straight-line method. However, if another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished that basis should be used. An example is the units-of-production method. Initial direct costs (see Section 2.12) should be deferred and allocated to income in proportion to the recognition of rental income over the lease term (see Section 2.6).

See Section 2.13.3 for discussion of lessor accounting for contingent rent.

An asset that is leased under an operating lease should be included with or near property, plant and equipment in the balance sheet and depreciated using the lessor's normal depreciation policy. In determining the lessor's normal depreciation policy it is important that the policy be established based on the planned use of the asset and its related useful life. If the lessor's intention is to lease a specific type of equipment under operating leases for a period of five years and then dispose of the equipment by sale, the lessor's depreciation policy would be based on a useful life of five years. The equipment would be depreciated to a residual value equal to the estimated fair value at the end of five years.

5.3.1 Operating lease example

The following illustrates the computation of the annual income from an operating lease using the lease example described in Section 5.2.1. The following illustration assumes the lessor plans to dispose of the asset by sale at the end of nine years and is depreciating the asset to its residual value. If the lessor intends to re-lease the asset for another two years, depreciation would be based on an 11-year life.

Illustration 5-4: Computing annual income from an operating lease			
Annual rental payment			\$ 10,000
Depreciation:			
Asset cost	\$ 64,100		
Residual value in 9 years	<u>(5,260)</u>		
Depreciable cost	58,840		
Straight-line depreciation factor	<u>÷ 9</u>		(6,538)
Initial direct cost amortization:			
Initial direct cost	1,000		
Rental income recognition factor	<u>÷ 9</u>		<u>(111)</u>
Annual income from lease			<u>\$ 3,351</u>

5.3.2 Time pattern of use of property in an operating lease

Operating lease agreements may specify scheduled rent increases over the lease term (see Section 2.6), or periods during the lease term for which rent payments are not required ("rent holidays"). Uneven rental payments (increases, decreases or holidays) are often designed to provide an inducement for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements or to acknowledge the time value of money. For operating leases that include uneven rental payments or rent holidays, rental revenue should be recognized by a lessor on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money or anticipated inflation is inappropriate because these factors do not relate to the physical usage of the leased property (ASC 840-20-25-2 – see Section 5.3).

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

The lessor should recognize the lease payments as follows:

- a. If rents escalate in contemplation of the lessee's physical use of the leased property (generally applicable to equipment only) but the lessee takes possession of or controls the physical use of the property at the beginning of the lease term, all rental payments including the escalated rents, should be recognized as rental revenue on a straight-line basis starting with the beginning of the lease term (ASC 840-20-25-3 – see Section 5.3).
- b. If rents escalate under a master lease agreement because the lessee gains access to and control over additional leased property at the time of the escalation, the escalated rents should be considered rental revenue attributable to the leased property and recognized in proportion to the additional leased property in the years that the lessee has control over the use of the additional leased property. The amount of rental revenue attributed to the additional leased property should be proportionate to the relative fair value of the additional property, as determined at the inception of the lease, in the applicable time periods during which the lessee controls its use (ASC 840-20-25-4 – see Section 5.3).

The application of these accounting provisions to an operating lease with uneven rental payments that are not in contemplation of the lessee's physical use of the property results in prepaid or accrued rentals to the lessor. If the lessee purchases the leased asset prior to the expiration of the lease term, any prepaid or accrued rentals should be included in the determination of the gain or loss on the cancellation of the lease and the sale of the asset. In the event the lease agreement is extended, the prepaid or accrued rent should be amortized over the remainder of the extended lease term.

5.3.2.1 Revenue recognition

A lessor begins recording revenue under an operating lease when the lessee takes (or has the right to take) possession of or controls the physical use of the property under the lease. It should be noted that this may be before or after lease payments begin. If the lessor turns the leased property over to the lessee so that the lessee can begin making lessee owned improvements to the property (e.g., lessee begins constructing lessee assets – leasehold improvements), then the lessor would begin recognizing rental income when the property is turned over to the lessee for that purpose. If instead, the lessor has determined that the lessee is acting on the lessor's behalf in constructing the improvements (e.g., lessee is constructing lessor assets) rental revenue would not begin until the leased property is substantially complete.

5.3.2.2 Impact of lessee vs. lessor asset on revenue recognition

Determining whether an improvement, which is paid for by the lessor, is a lessee or lessor asset (see Section 4.3.4) generally impacts the determination of when the lessee takes possession of or controls the physical use of the property under the lease (and, consequently, impacts when the lessor can begin recognizing operating lease revenue). The lessee generally has not taken possession of or control of the leased asset until it is substantially complete. The following illustration demonstrates this point:

Illustration 5-5: Impact of lessee vs. lessor asset on revenue recognition

Assume Lessee A contracts to lease a building from Lessor B. Lessor B agrees to reimburse Lessee A for \$10 million of improvements (e.g., carpeting, interior walls and similar improvements that will be installed before the lessee occupies and begins to use the property for its intended purpose) as specified in the lease agreement. If Lessor B determines that it owns the leasehold improvements it would record rental income on a straight-line basis once the lessee has possession of or controls physical use of the space (generally when the building and improvements are substantially complete). However, if Lessor B determines that it does not own the leasehold improvements, it would record rental income on a straight-line basis once the lessee takes possession or controls the physical use of the property. In this instance, the lessee would have possession of the space when it has access to begin constructing its improvements. The fact that the lessee may delay the date when they occupy the space (i.e., enter to make or have their agent make improvements) is not relevant – instead control and possession are based on the lessee's rights to possess or use. Additionally, if Lessor B determines the improvements are lessee assets, Lessor B would be required to recognize the \$10 million as a leasehold incentive (see Section 5.3.3.1) and would record a liability for the incentive once incurred.

5.3.3**Lease incentives in an operating lease – lessor**

Payments made to or on behalf of the lessee represent incentives that should be considered reductions of rental revenue by the lessor over the term of the new lease. Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered an incentive by the lessor. Incentives should be recognized on a straight-line basis over the term of the new lease. The lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed leased property (ASC 840-20-25-6 through 25-7 – see Section 5.3).

The following example illustrates the accounting by a lessor for lease incentives:

Excerpt from Accounting Standards Codification**Leases – Operating Leases***Implementation Guidance and Illustrations***840-20-55-3**

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

Lessor Accounting

At inception:

Incentive to lessee	\$	1,000	
Liability on sublease assumed			\$ 1,000
<i>To record deferred cost and liability related to loss on assumption of remaining lease</i>			

Recurring journal entries in Years 1-4:

Liability on sublease assumed (\$1,000 ÷ 4 years)	\$	250	
Sublease expense		550	
Cash			\$ 800
<i>To record cash payment on sublease assumed and amortization of the liability on the sublease assumed</i>			

Cash	\$	550	
Sublease revenue			\$ 550
<i>To record cash received from sublease of the property</i>			
Recurring journal entries in Years 1-8:			
Cash	\$	1,200	
Rental revenue			\$ 1,075
Incentive to lessee (\$1,000 ÷ 8 years)			125
<i>To record cash received on new lease and amortization of incentive over new lease term</i>			
[Note: Lessee accounting has been excluded. See Section 4.3.4 for lessee accounting.]			

5.3.3.1 Lease incentives and tenant improvements

An operating lease agreement with a new lessor may include incentives for the lessee to enter into the lease, such as an up-front cash payment to the lessee, payment of certain costs for the lessee (such as moving expenses or leasehold improvements) or the assumption by the lessor of the lessee's preexisting lease with a third party. Payments made to, or on behalf of, the lessee represent incentives that should be considered reductions of rental revenue by the lessor over the term of the lease. Incentives should be recognized on a straight-line basis over the term of the lease and excluded from minimum lease payments (see Section 2.9) for determining lease classification.

When a lessor makes an upfront payment to the lessee to fund (or partially fund) lessee asset improvements, the incentive is recorded as a receivable by the lessor (i.e., a credit to cash and an offsetting debit to lease incentive receivable). As payments are received by the lessor under the lease, a portion (incentive ÷ lease term) of those payments are, in substance, repayments of the incentive (that is, a credit to the lease incentive receivable and an offsetting debit to cash). The fact that the incentive paid by the lessor is earmarked specifically to reimburse the lessee for the cost of the new leasehold improvements (lessee assets) does not impact the accounting for the incentive. That is, even if the funding is designated to partially or fully fund the lessee's leasehold improvements, the lessor would still record an incentive receivable. This accounting would also apply if, instead of receiving and paying cash, the lessee simply submits invoices to the lessor for a prescribed amount of improvements that are determined to be lessee assets and that the lessor has agreed to fund.

5.3.4 Renewal or extension of an operating lease

An existing lease is considered a new lease agreement for accounting purposes when it is renewed or extended beyond the original lease term (see Section 2.6 for further discussion of lease term). The exercise of a renewal option included as part of the original lease term does not create a new lease for accounting purposes as that renewal was already included in the existing lease accounting (e.g., included in the assessment of lease classification and determining straight-line rentals). However, the exercise of a renewal option that was not deemed part of the original lease term, or entering into a new agreement that goes beyond the original lease term, would automatically create a new lease for accounting purposes (see Section 3.4 for further details).

A new lease should be accounted for by the lessor as a sales-type, direct financing or operating lease based on the lease classification as of the date of extension or renewal. If the term of an operating lease is extended (e.g., original lease term 24 months, extended to 36 months), the deferred rent credit should be amortized over the remaining term of the revised lease, regardless of whether the new lease is an operating, direct financing or sales-type lease.

5.3.5 Change in operating lease other than extending the lease term

A change in an operating lease agreement other than to extend the lease term that results in a new lease (see Section 3.4.1) should be accounted for by the lessor as a sales-type, direct financing or operating lease based on the lease classification as of the date of modification. If a change in an operating lease does not result in a new lease, the lessor should continue operating lease accounting and any accrued or deferred rents should be amortized over the remaining lease term.

5.3.6 Termination of an existing operating lease

As consideration for the early termination of a lease, a lessor may receive either a fee or increased lease payments from the lessee over the shortened lease term. A lease modification to change the expiration of a lease should be accounted for by a lessor in accordance with ASC 840-10-35-4 (see Section 3.4). As such, to the extent an operating lease term is shortened and the shortened lease is also an operating lease, no gain should be recognized by the lessor unless the fee or payment is agreed to and received concurrent with the termination of the lease (i.e., the lease is modified and terminated concurrently). That is, any incremental fees or increased lease payments should be recognized over the remaining lease term. Noteworthy is that consideration of the accounting impact of the termination penalty, as discussed in Section 4.3.8.1, does not apply to lessors. The following illustrations demonstrate this concept.

Illustration 5-6: Accounting for the termination of an operating lease

Lessee A leases a floor in an office building from Lessor B under an 9-year operating lease beginning 1 January 20X1 (lease expires 31 December 20X9) for monthly lease payments of \$30,000. During 20X6, the Lessee A determines that it no longer requires the leased space. On 31 December 20X6, Lessee A and Lessor B execute an amendment to the lease whereby Lessee A agrees to immediately exit (i.e., on 31 December 20X6) and surrender its right to use the leased space and pay a \$300,000 termination penalty to Lessor B. Assuming no other balance sheet items exist, Lessor B would recognize a gain of \$300,000 on the termination of the lease as of 31 December 20X6.

Illustration 5-7: Accounting for a modification to shorten an operating lease

Assume the same facts as in Illustration 5-6 above, except that on 31 December 20X6, Lessee A and Lessor B execute an amendment to the lease whereby Lessee A agrees to pay increased monthly rentals of \$45,000 for the next 12 months, exit and surrender its right to use the leased space effective 31 December 20X7 and pay a \$120,000 termination penalty to Lessor B on 31 December 20X7 (lease termination date). Had the revised terms been in place as of the inception of the lease, the lease would have still have been classified as an operating lease. Lessor B should recognize the increased monthly rentals and the termination penalty on a straight-line basis over the remaining term of the lease. Lessor B would recognize monthly rental revenue of \$55,000 over the twelve-months ended 31 December 20X7 calculated as follows:

Monthly rental payments	\$ 45,000
Lease term in months	X 12
Subtotal	540,000
Termination penalty	<u>120,000</u>
Total	660,000
Lease term in months	÷ 12
Monthly rental revenue	<u>\$ 55,000</u>

5.3.7 Asset impairment – operating leases

Assets leased out under an operating lease should be assessed for impairment, as necessary, under the provisions of ASC 360-10. See our Impairment or disposal of long-lived assets FRD for further discussion on assessing an asset for impairment.

5.4 Participation by third parties

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Derecognition

840-30-40-8

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 Subtopic 860. Paragraph 860-10-55-6 states that unguaranteed residual values do not meet the definition of financial assets, nor do residual values guarantees after the inception, and transfers of them are not subject to the requirements of Subtopic 860-10.

840-30-40-9

For an illustration of a lessor's accounting for a transfer of an interest in minimum lease payments from a sales-type lease, see Example 5 (paragraph 860-20-55-58).

Transfers and Servicing – Overall

Implementation Guidance and Illustrations

860-10-55-6

Sales-type and direct financing receivables secured by leased equipment, referred to as gross investment in lease receivables, are made up of two components: minimum lease payments and residual values. Minimum lease payments are requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Thus, transfers of minimum lease payments are subject to the requirements of this Subtopic. Residual values represent the lessor's estimate of the salvage value of the leased equipment at the end of the lease term and may be either guaranteed or unguaranteed. Residual values meet the definition of financial assets to the extent that they are guaranteed at the inception of the lease. Thus, transfers of residual values guaranteed at inception also are subject to the requirements of this Subtopic. Unguaranteed residual values do not meet the definition of financial assets, nor do residual values guaranteed after inception, and transfers of them are not subject to the requirements of this Subtopic.

5.4.1 Sale or assignment of lease by a lessor

The original accounting for a sales-type or direct financing lease is not changed if the lease or the leased property is subsequently sold or assigned to a third party. The accounting for sale or assignment of the minimum lease payments receivable and any residual value guaranteed at lease inception relating to a sales-type or direct financing lease (including leveraged leases), is addressed by the provisions of ASC 860, *Transfers and Servicing*. ASC 860 does not apply to operating leases (see Section 5.4.5).

Pursuant to the relevant provision of ASC 860, sales-type and direct financing receivables (gross investment in lease receivables) are made up of two components: lease receivables and residual values. Lease receivables represent requirements for lessees to pay cash to lessors and meet the definition of a financial asset. Thus, transfers of lease receivables are subject to the requirements of ASC 860. The residual value component meets the definition of a financial asset only if it is guaranteed (by a third party) at the inception of the lease. Transfers of guaranteed residual values that are guaranteed at the

inception of the lease are subject to the derecognition requirements of ASC 860, while transfers of unguaranteed residual values and guaranteed residual values that are guaranteed subsequent to the inception of the lease are not (see Section 5.4.4). As a result, if an unguaranteed residual value or a residual value that is guaranteed subsequent to lease inception exists as part of the gross investment, entities selling or securitizing all or part of lease financing receivables (without transferring title to the underlying asset or their right to the remaining unguaranteed residual value) should allocate the gross investment in receivables between minimum lease payments (including guaranteed residual value) and unguaranteed residual values (or residual value guaranteed after inception) using the individual carrying amounts of those components at the date of transfer. The allocated amount of financial assets being transferred (minimum lease payments and residual value guaranteed at inception of the lease) will represent the carrying amount to be used in the determination of gain or loss if the transfer meets the derecognition requirements of ASC 860. The unguaranteed residual value (or residual value guaranteed after inception) is subject to evaluation under ASC 840-20-40-3 through 40-4 (see Sections 5.4.4 and 5.5 for further details). Entities also should recognize a servicing asset or liability in accordance with ASC 860, if applicable. The following example illustrates this allocation.

Excerpt from Accounting Standards Codification

Transfers and Servicing – Sales of Financial Assets

Implementation Guidance and Illustrations

Transfer of Lease Financing Receivables with Residual Values

860-20-55-58

This Example illustrates the guidance in paragraph 860-20-25-1. At the beginning of the second year in a 10-year sales-type lease, Entity E transfers for \$505 a nine-tenths participating interest in the minimum lease payments to an independent third party, and the transfer is accounted for as a sale. Entity E retains a one-tenth participating interest in the minimum lease payments and a 100 percent interest in the unguaranteed residual value of leased equipment, which is not subject to the requirements of this Subtopic as discussed in paragraph 860-10-55-6 because it is not a financial asset and, therefore, is excluded from the analysis of whether the transfer of the nine-tenths participating interest in the minimum lease payments meets the definition of a participating interest. The servicing asset has a fair value of zero because Entity E estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities. The carrying amounts and related gain computation are as follows.

Carrying amounts

Minimum lease payments		\$ 540
Unearned income related to minimum lease payments		<u>370</u>
Gross investment in minimum lease payments		910
Unguaranteed residual value	\$ 30	
Unearned income related to unguaranteed residual value	<u>60</u>	
Gross investment in unguaranteed residual value		<u>90</u>
Total gross investment in financing lease receivable		<u>\$ 1,000</u>

Gain on sale

Cash received		\$ 505
Nine-tenths of carrying amount of gross investment in minimum lease payments	\$ 819	
Nine-tenths of carrying amount of unearned income related to minimum lease payments	<u>333</u>	
Net carrying amount of minimum lease payments sold		<u>486</u>
Gain on sale		<u>\$ 19</u>

860-20-55-59

The following journal entry is made by Entity E:

Journal entry

Cash		\$	505	
Unearned income			333	
Lease receivable				\$ 819
Gain on sale				19
<i>To record sale of nine-tenths of the minimum lease payments at the beginning of Year 2</i>				

As discussed above, only transfers of guaranteed residual values that were guaranteed at the inception of the lease are subject to the derecognition requirements of ASC 860. If the lessee guarantees the residual value, the minimum lease payments (including the residual value guaranteed by the lessee) should be viewed as a single unit of account pursuant to ASC 860. If a third party guarantees the residual value, we believe the guaranteed residual value can be considered a separate unit of account) pursuant to ASC 860. Whether a third party residual value guarantee should be considered a separate unit of account or combined with the payments due from the lessee into a single unit of account pursuant to ASC 860 is an accounting policy election.

See our Transfers and services of financial assets FRD for further information.

For a discussion of the assignment of a lease by the lessee, see Section 12.

5.4.2**Lessor accounting for retained interest in the residual value of a leased asset on sale of lease receivables****Excerpt from Accounting Standards Codification****Leases – Capital Leases****Subsequent Measurement****840-30-35-53**

If a lessor sells substantially all of the minimum rental payments associated with a sales-type, direct financing, or leveraged lease and retains an interest in the residual value of the leased asset, the lessor shall not recognize increases in the value of the lease residual to its estimated value over the remaining lease term. The lessor shall report any remaining interest thereafter at its carrying amount at the date of the sale of the lease payments. If it is determined subsequently that the fair value of the residual value of the leased asset has declined below the carrying amount of the interest retained and that decline is other than temporary, the asset shall be written down to fair value, and the amount of the write-down shall be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset shall not be increased for any subsequent increase in its fair value before its sale or disposition.

In certain instances, a lessor will sell lease receivables (i.e., the minimum lease receivable recorded in a sales-type or a direct financing lease) but retain an interest in the residual value of the leased assets. A common example of this type of transaction is when a lessor securitizes lease receivables where the lessor has the infrastructure to dispose of the leased asset and handle the residual value risk, and accordingly, retains all interests in the residual value or guarantees the residual value to the investor. A lessor retaining an interest in the residual value of the leased asset should not recognize increases in the value of the lease residual to its estimated value over the remaining lease term (unless the residual value is guaranteed – see Section 5.4.3).

If the lessor that sold a portion of the outstanding lease receivable retains a significant (10% or more) interest in the outstanding receivable balance (computed on a present value basis), the seller-lessor will still be considered a lessor pursuant to ASC 840, and accordingly, continuing the accretion of the residual value is appropriate. If however, the lessor does not retain a significant interest in the receivable balance, the lessor should account for the residual value interest at its carrying amount at the date of the sale of the lease receivable. If it is subsequently determined that the fair value of the residual value of the leased asset has declined below the carrying amount of the interest retained and that decline is other than temporary, the asset should be written down to fair value, and the amount of the write-down should be recognized as a loss. That fair value becomes the asset's new carrying amount, and the asset should not be increased for any subsequent increase in its fair value prior to its sale or disposition. As a result, a lessor that retains an interest in the residual value of a leased asset and sells the stream of lease payments is prohibited from recognizing any gain on that residual value until the sale or disposal of the underlying asset. Gain or loss on the sale of the lease receivable is governed by ASC 860 and the sale of the unguaranteed residual is governed by ASC 840-20-40-3 through 40-4 (see Section 5.5).

5.4.3 Accounting for a guaranteed residual value

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Subsequent Measurement

840-30-35-21

An interest in the residual value of a leased asset is a financial asset to the extent guaranteed at lease inception and, thus, increases to its estimated value over the remaining lease term shall be recognized.

A residual value of a leased asset is a financial asset to the extent of the guarantee of the residual value at the inception of the lease by the lessee or a third party unrelated to the lessor. Accordingly, increases and decreases in a guaranteed residual value that qualifies as a financial asset (see Section 5.4.1) should be recognized over the remaining lease term.

5.4.4 Sale of unguaranteed residual value with or without a sale of minimum lease payments

If in conjunction with a sale of lease receivables (in accordance with ASC 860), a lessor also sells to a third party its interest in an unguaranteed residual value or in a residual interest that was guaranteed subsequent to the inception of the lease, the gain or loss on the sale of the residual value should be recognized in earnings (see Section 5.4.1) if it qualifies as a sale in accordance with ASC 840-20-40-3 through 40-4 (see Section 5.5). If the lessor sells the unguaranteed residual value or a guaranteed residual value that was guaranteed subsequent to the inception of the lease to a third party, without selling the lease receivable, the gain or loss represents a revision in the estimate of the residual value based on a completed transaction and should be recognized at the time of the sale. It would not be appropriate to defer a gain or loss on the sale of an unguaranteed residual value or a guaranteed residual value that was guaranteed after the inception of the lease over the remaining lease term.

5.4.5 Sale or assignment of operating lease payment by a lessor

As required by ASC 840-20-35-5, the sale or assignment by the lessor of lease payments due under an operating lease is accounted for as a borrowing as described in Section 5.5 regardless of whether substantial risks have been retained.

5.5 Lessor's sale of assets subject to a lease or that are intended to be leased by the purchaser to a third party

Excerpt from Accounting Standards Codification

Leases – Operating Leases

Subsequent Measurement

840-20-35-4

If a transfer 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 guidance in paragraphs 840-20-40-3 through 40-4, the transaction shall be accounted for as a borrowing as follows:

- a. The proceeds from the transfer shall be recorded as an obligation on the books of the lessor-transferor.
- b. 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 lessor-transferor, even if such rentals are paid directly to the third-party purchaser.
- c. A portion of each rental shall be recorded by the lessor-transferor as interest expense, with the remainder to be recorded as a reduction of the obligation.
- d. The interest expense shall be calculated by application of a rate determined in accordance with the guidance in Subtopic 835-30.
- e. The leased property shall be accounted for by the lessor as prescribed in the preceding paragraph and paragraphs 840-20-45-2 through 45-3 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.

840-20-35-5

The sale or assignment by the lessor of lease payments due under an operating lease shall be accounted for as a borrowing as described in the preceding paragraph.

Derecognition

840-20-40-3

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 circumstance of default by the lessee or termination of the lease, the arrangements may involve a formal or informal commitment by the seller to do any of the following:

- a. Acquire the lease or the property
- b. Substitute an existing lease
- c. Secure a replacement lessee or a buyer for the property under a remarketing agreement.

840-20-40-4

However, a remarketing agreement by itself shall not disqualify accounting for the transaction as a sale if both of the following conditions are met:

- a. The seller will receive a reasonable fee commensurate with the effort involved at the time of securing a replacement lessee or buyer for the property.
- b. The seller 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 [FIFO] remarketing arrangement is considered to be a priority.)

840-20-40-5

If a transfer 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 guidance in paragraph 840-20-40-3, the transaction shall be accounted for as a borrowing in accordance with the guidance in paragraph 840-20-35-4. (Transactions of these types are in effect collateralized borrowings.)

The sale of property subject to an operating lease, or property that is leased or intended to be leased by the third party purchaser, shall not be treated as a sale when the seller retains substantial risks of ownership.

If at the time of sale, the seller is able to determine that the buyer (irrespective of any enhancement provided by the seller) will lease the asset to a third party under a sales-type or direct financing lease (as such lease would be accounted for if the seller entered into the lease), then recognition of the sale is appropriate. This is due to the fact that the substantial risks and rewards of ownership have passed to the lessee. In practice, however, it is often not known at the time of sale what type of lease the buyer will enter into, thus requiring the seller to assume it will be an operating lease.

If substantial risks (i.e., if the present value of the retained risk is 10% or more of the leased asset's fair value) of ownership are retained (e.g., by guaranteeing recovery of the investment, by guaranteeing the residual value of the leased asset to the purchaser, or by deferring a portion of the selling price until the uncertainty is resolved or having other forms of contingent consideration), the seller should account for the sale as a borrowing by recording the proceeds as a liability. The rental payments made by the lessee (whether to the seller or the third-party purchaser) should be recorded as revenue. The offsetting debits are to the liability and to interest expense. The seller accounts for the asset sold as if it was leased out under an operating lease with the depreciable life limited to the estimated period over which the liability arising from the sale will be outstanding.

Consistent with the basic premises of lease accounting under ASC 840, substantial risk, as contemplated in ASC 840-20-40-3, is measured on a transaction-by-transaction basis versus a pool concept that would encompass multiple transactions and remain open for an extended period of time. From a practical standpoint, the sale of similar equipment over a relatively short period of time (e.g., less than 90 days), with similar residual value curves that will be leased for comparable periods to lessees with the same credit risk, may be treated as one transaction for purpose of applying this provision. That is, we have accepted pools when the protection provided to the buyer is no greater than if granted on a transaction-by-transaction basis.

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. An obligation to repurchase the asset, even if the purchase were at fair value, would be an example of retaining substantial risk of ownership whereas a right of first refusal would not.

At the December 1999 AICPA Conference on Current SEC Developments, an SEC Professional Accounting Fellow noted that in the SEC's view, credit risk represents ownership risk for purposes of evaluating "substantial risk." The SEC staff believes that a direct or indirect guarantee of lease payments represents the retention of a risk of ownership in the leased property and, accordingly, if the risk retained is substantial, the transaction must be accounted for as a financing and not a sale.

When the sale is to a related party (see Section 7.1) that is not consolidated (e.g., sale to a joint venture accounted for under the equity method), profit recognition on the portion of the sale equal to the third party ownership percentage is appropriate as long as substantial risks of ownership have not been retained. In determining if substantial risks of ownership have been retained the limit on 10% risk retained should be determined based on the proportion that is a sale to a third party. For example, if a company sells equipment for \$100 to a 50/50 joint venture, the significance of the risk retained would be based on \$5 ($\$100 \times 50\% \times 10\%$).

5.5.1 **Accounting for guarantees related to lessor's sale of assets subject to a lease or that are intended to be leased by the purchaser to a third party**

In addition to the considerations discussed above for lessors where the sale of the asset is subject to a lease or the asset is intended to be leased by the purchaser to a third party following the sale, the guidance in ASC 460, *Guarantees*, may apply. If the seller/lessor assures recovery of the investment by the third-party purchaser and thus retains substantial risks in connection with the property, then the seller/lessor is precluded from using sales accounting as noted above. If the guarantee is an impediment to sales accounting, then the transaction is excluded from the scope of ASC 460 (ASC 460-10-15-7(g)). However, if the guarantee does not preclude the use of sales accounting (i.e., the present value of the risk retained by the seller/lessor is less than 10% of the leased asset's fair value), then the guarantee is subject to the guidance in ASC 460.

Under ASC 460, the seller would be required to record a liability for the fair value of the obligation (e.g., the guarantee of the purchaser's recovery of the investment) at the inception of the guarantee. For guarantees issued in connection with a sale, fair value represents the premium that would have been received had the guarantee been issued in a standalone transaction. Because quoted market prices in active markets are not likely to be available, many entities will be required to estimate the fair value of a guarantee based on the expected present value of contingent payments under the guarantee arrangement.

The framework for fair value measurement prescribed in ASC 820, *Fair Value Measurement*, should be applied to determine the fair value of the liability under ASC 460. However, it should be noted that ASC 820 does not eliminate the practicability exception that exists in ASC 460 with respect to fair value measurement when a premium is received or receivable. See our Fair value measurements and disclosures FRD for further discussion on determining fair value.

ASC 460 does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee. However, ASC 460 provides an illustration of a guarantee issued in connection with the sale of assets and suggests that the overall proceeds (such as the cash received or the receivable) would be allocated between the consideration being remitted to the guarantor for issuing the guarantee and the proceeds from the sale of the asset.

The seller should subsequently account for the liability related to the guarantee by reducing the liability as it is released from risk. Three methods noted in ASC 460 used to measure and recognize reductions in risk are:

- ▶ Upon expiration or settlement of the guarantee
- ▶ By a systematic and rational amortization method
- ▶ As the fair value of the guarantee changes

Determining how and when risk is released from the residual value guarantee will be based on individual facts and circumstances.

Note that the guidance in ASC 460 was codified primarily from FIN 45, which is applicable to guarantees issued or modified after 31 December 2002.

5.5.2 Impact of a remarketing or a management agreement on a lessor's sale of assets

A remarketing agreement does not create a substantial risk of ownership if the seller will receive a reasonable fee for securing a replacement lessee or a buyer for the property and no priority over similar property produced or owned by the seller is given to re-leasing or disposing of the property. A first-in, first-out remarketing arrangement or a buyer's option to put the equipment back to the seller, even at fair value, would be considered granting the buyer a priority.

Management agreements, whereby the seller manages the leased asset on behalf of the buyer immediately after sale, typically involve assets that are leased out to third parties where the seller has the infrastructure to manage the leased assets. As with a remarketing agreement, if the seller will receive a reasonable fee for locating lessees and no priority over similar property produced or owned by the seller is given to leasing the property, substantial risk of ownership is not retained. A first-in, first-out management arrangement is a priority.

5.5.3 Sale of equipment where seller guarantees resale amount

Excerpt from Accounting Standards Codification

Leases – Overall

Implementation Guidance and Illustrations

840-10-55-12

This implementation guidance addresses the application of the General Subsections of this Subtopic in the following circumstances. A manufacturer sells equipment with an expected useful life of several years to end users (purchasers) utilizing various sales incentive programs. Under one such sales incentive program, the manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, contingent on certain requirements.

840-10-55-13

The manufacturer provides the guarantee by agreeing to do either of the following:

- a. Reacquire the equipment at a guaranteed price at specified time periods as a means to facilitate its resale
- b. Pay the purchaser for the deficiency, if any, between the sales proceeds received for the equipment and the guaranteed minimum resale value.

There may be dealer involvement in these types of transactions, but the minimum resale guarantee is the responsibility of the manufacturer.

840-10-55-14

A manufacturer is precluded from recognizing a sale of equipment if the manufacturer guarantees the resale value of the equipment to the purchaser. Rather, the manufacturer should account for the transaction as a lease, using the principles of lease accounting in this Subtopic.

840-10-55-15

The minimum lease payments used as part of the determination of whether the transaction should be classified as an operating lease or as a sales-type lease, generally will be the difference between the proceeds upon the equipment's initial transfer and the amount of the residual value guarantee to the purchaser as of the first exercise date of the guarantee.

840-10-55-16

If the transaction qualifies as an operating lease, the net proceeds upon the equipment's initial transfer should be recorded as a liability in the manufacturer's balance sheet.

840-10-55-17

The liability is then subsequently reduced on a pro rata basis over the period to the first exercise date of the guarantee, to the amount of the guaranteed residual value at that date, with corresponding credits to revenue in the manufacturer's income statement. Any further reduction in the guaranteed residual value resulting from the purchaser's decision to continue to use the equipment should be recognized in a similar manner.

840-10-55-18

The equipment should be included in the manufacturer's balance sheet and depreciated following the manufacturer's normal depreciation policy.

840-10-55-19

The Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 provides guidance on the accounting for any potential impairment of the equipment.

840-10-55-20

At the time the purchaser elects to exercise the residual value guarantee by selling the equipment to another party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any remaining liability should be removed from the balance sheet and included in the determination of income of the period of the equipment's sale.

840-10-55-21

Alternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be reduced by the amount paid to the purchaser. Any remaining liability should be included in the determination of income of the period of the exercise of the guarantee.

840-10-55-22

The accounting for a guaranteed minimum resale value is beyond the scope of Topic 815. In the transaction described, the embedded guarantee feature is not an embedded derivative instrument that must be accounted for separately from the lease because it does not meet the criterion in paragraph 815-15-25-1(b).

840-10-55-23

Specifically, if freestanding, the guarantee feature would be excluded from the scope of paragraph 815-10-15-59(b) because of both of the following conditions:

- a. It is not exchange-traded.
- b. The underlying on which settlement is based is the price of a nonfinancial asset of one of the parties and that asset is not readily convertible to cash. It is assumed that the equipment is not readily convertible to cash, as that phrase is used in Topic 815.

840-10-55-24

Paragraph 815-10-15-59(b)(2) states that the related exception applies only if the nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset. (In some circumstances, the exclusion in paragraph 815-10-15-63 would also apply.)

840-10-55-25

Lastly, Topic 460 does not affect the guarantor's accounting for the guarantee because that Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's net investment in the lease) if recording a sales-type lease, that guarantee does not meet the characteristics in paragraph 460-10-15-4 and is, therefore, not subject to the guidance in Topic 460. Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of that Topic and the guidance in paragraph 840-10-55-16 for an operating lease is not affected. As a result, the guarantor's accounting for the guarantee is unaffected by Topic 460.

Leases – Capital Leases***Implementation Guidance and Illustrations*****840-30-55-21**

Paragraphs 840-10-55-12 through 55-25 provides implementation guidance on applying the guidance in the Leases Topic to a transaction in which a manufacturer-lessor contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is leased under a sales-type lease.

Although not a lease transaction, in some transactions, a manufacturer sells equipment utilizing a sales incentive program. Under the sales incentive program, the manufacturer contractually guarantees that the purchaser will receive a minimum resale amount at the time the equipment is disposed of, contingent on certain requirements. This guarantee is provided by agreeing to (1) reacquire the equipment at a guaranteed price at specified time period as a means to facilitate its resale, or (2) pay the purchaser for the deficiency, if any, between the sales proceeds received for equipment and the guaranteed minimum resale value. Although a third party dealer may be involved in this type of transaction, the minimum resale guarantee remains the responsibility of the manufacturer.

A manufacturer is precluded from recognizing a sale of equipment if the manufacturer guarantees the resale value of the equipment to the purchaser, and should account for the arrangement as a lease. The minimum lease payments used as a part of the determination of whether the transaction should be classified as an operating lease or as a sales-type lease, generally will be the difference between the proceeds on the equipment's initial transfer and the amount of the residual value guarantee to the purchaser as of the first exercise date of the guarantee.

It is our view that the guaranteed resale (residual) should be viewed on a net present value basis in determining if the transaction is a sales-type or operating lease.

Illustration 5-8: Accounting for a sale where the seller provides a guarantee of the resale amount

Company X sells a computer with a cost of \$80 for \$100 and agrees to reacquire the equipment in five years for \$10. The present value of the \$10 repurchase obligation is \$6. As a result, the transaction qualifies as a sales-type lease because the proceeds on sale less the present value of the repurchase obligation exceed 90% of the computers' fair value. The following entries would be recorded:

Cash (received at time of sale)	\$	100		
Sales			\$	100
Cost of sale	\$	80		
Inventory			\$	80
Residual value of asset sold	\$	6		
Guaranteed repurchase obligation			\$	6

Both the residual value and the guarantee should be accreted to \$10 at the end of the 5-year period. If at any time the residual value of the computer is deemed to be less than \$10, a loss for the shortfall should be recorded.

If the transaction should be accounted for by the manufacturer as an operating lease, the net proceeds on the equipment's initial transfer should be recorded as a liability in the manufacturer's balance sheet. The liability subsequently would be reduced on a pro rata basis over the period to the first exercise date of the guarantee, to the amount of the guaranteed residual value at that date, with corresponding credits to revenue in the manufacturer's income statement. Any further reduction in the guaranteed residual value resulting from the purchaser's decision to continue to use the equipment should be recognized in a similar manner. The equipment should be included in the manufacturer's balance sheet and depreciated following the manufacturer's normal depreciation policy. ASC 360-10 provides guidance on the accounting for any potential impairment of the equipment. At the time the purchaser elects to exercise the residual value guarantee by selling the equipment to another party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any remaining liability should be removed from the balance sheet and included in the determination of income in the period of the equipment's sale. Alternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be reduced by the amount paid to the purchaser. Any remaining liability should be included in the determination of income in the period of the exercise of the guarantee.

ASC 460 does not apply to a guarantee for which the underlying is related to an asset of the guarantor (ASC 460-10-55-17(e)). Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's net investment in the lease) when recording a sales-type lease, that guarantee does not meet the characteristics in ASC 460-10-15-4 and is, therefore, not subject to the provisions of ASC 460. Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of ASC 460 and, as a result, the accounting prescribed in ASC 840-10-55-12 through 55-25 is unaffected by ASC 460.

ASC 840 does not address a transaction where the seller can be required by the buyer, at a specified time subsequent to the sale, to repurchase the asset at fair value as determined at the time of the buyback. Because the buyback at fair value does not expose the seller to a risk of loss (the asset bought back could be sold to another party at fair value), an ordinary sale can be recorded. The amount of profit recognition would, however, be subject to a facts and circumstances evaluation considering among other things, anticipated fair value on buyback versus sales price, and the proximity of the potential buyback to the original sale.

ASC 840 also does not address the accounting for an arrangement that gives a customer the right to trade-in an asset at a guaranteed value or specified price that can only be exercised when the customer purchases a new asset or require arrangements that include such rights to be accounted for as a lease.

5.5.4

Manufacturers' sales to entities that lease

Excerpt from Accounting Standards Codification

Leases – Overall

Relationships

840-10-60-3

For guidance on whether a manufacturer is precluded from recognizing a sale of a product to a dealer if the customer subsequently enters into an operating lease with the manufacturer or its finance affiliate that acquires the product subject to the lease, see paragraph 605-15-25-5.

Revenue Recognition – Products

Recognition

605-15-25-5

If, as described in paragraph 605-15-05-6, a manufacturer sells a product to a dealer and the customer subsequently enters into an operating lease with the manufacturer or its finance affiliate that acquires that product subject to the lease, the manufacturer may recognize a sale at the time the product is transferred to the dealer if all of the following conditions exist:

- a. The dealer is a substantive and independent entity that transacts business separately with the manufacturer and customers.
- b. The manufacturer has delivered the product to the dealer, and the risks and rewards of ownership have passed to the dealer, including responsibility for the ultimate sale of the product and for insurability, theft, or damage. A customer's failure to enter into a lease with the finance affiliate (or manufacturer) would not allow the dealer to return the product to the manufacturer.
- c. The finance affiliate (or manufacturer) has no legal obligation to provide a lease arrangement to a potential customer of the dealer at the time the product is delivered to the dealer.
- d. The customer has other financing alternatives available from parties unaffiliated with the manufacturer, and the customer is in control of the selection from the financing alternatives.

In certain instances, a manufacturer sells equipment to dealers that, in turn, sell or lease the products to end users (customers). An issue arises as to the ability of the manufacturer to recognize the sale if the manufacturer (or a finance entity related to the manufacturer) provides financing to the end users to purchase the equipment (either in the form of a loan or lease financing).

A manufacturer would not be precluded from recognizing a sale at the time the product is transferred to the dealer if all of the following conditions exist:

1. The dealer is a substantive and independent enterprise that transacts business separately with the manufacturer and customers.
2. The manufacturer has delivered the product to the dealer, and the risks and rewards of ownership have passed to the dealer, including responsibility for the ultimate sale of the product and for insurability, theft or damage. A customer's failure to enter into a lease with the finance affiliate (or manufacturer) would not allow the dealer to return the product to the manufacturer.
3. The finance affiliate (or manufacturer) has no legal obligation to provide a lease arrangement to a potential customer of the dealer at the time the product is delivered to the dealer.
4. The customer has other financing alternatives available from parties unaffiliated with the manufacturer, and the customer is in control of the selection of the financing alternatives.

The key difference between a transaction that is eligible for sale treatment (meeting the above four criteria) versus a transaction for which sale treatment is prohibited under ASC 840-20-40-3 (sale to an entity that leases where substantial risk is maintained by the seller – see Section 5.5), is that a sale meeting the four criteria discussed above is assumed not to involve a retention of "substantial risk" by the seller.

5.6

Disclosures

Excerpt from Accounting Standards Codification

Leases – Overall

Disclosures

840-10-50-4

If leasing, exclusive of leveraged leasing, is a significant part of the lessor's business activities in terms of revenue, net income, or assets, a lessor shall disclose in the financial statements or footnotes thereto a general description of the lessor's leasing arrangements.

840-10-50-5

The lessor shall disclose its accounting policy for contingent rental income. If a lessor accrues contingent rental income before the lessee's achievement of the specified target (provided achievement of that target is considered probable), disclosure of the impact on rental income shall be made as if the lessor's accounting policy was to defer contingent rental income until the specified target is met.

Leases – Operating Leases

Disclosures

840-20-50-4

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

- a. 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

- b. 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
- c. Total contingent rentals included in income for each period for which an income statement is presented.

840-20-50-4A

Example 1 (see paragraph 840-10-55-47) illustrates the application of the preceding paragraph.

Leases – Capital Leases

Disclosures

840-30-50-4

If leasing, exclusive of leveraged leasing, is a significant part of the lessor's business activities in terms of revenue, net income, or assets, all the following information with respect to sales-type and direct financing leases shall be disclosed in the financial statements or footnotes:

- a. All of the following components of the net investment in sales-type and direct financing leases as of the date of each balance sheet presented:
 - 1. Future minimum lease payments to be received, with separate deductions for both of the following:
 - (i) Amounts representing executory costs (including any profit thereon) included in the minimum lease payments
 - (ii) The accumulated allowance for uncollectible minimum lease payments receivable.
 - 2. The unguaranteed residual values accruing to the benefit of the lessor
 - 3. For direct financing leases only, initial direct costs
 - 4. Unearned income (see paragraphs 840-30-30-9 and 840-30-30-13).
- b. 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
- c. Total contingent rentals included in income for each period for which an income statement is presented.

Example 1 (see paragraph 840-10-55-47) illustrates certain disclosures.

840-30-50-4A

For guidance on disclosures about financing receivables, which includes receivables relating to a lessor's rights to payments from sales-type and direct financing leases, see the guidance beginning in paragraphs 310-10-50-5A, 310-10-50-11A, 310-10-50-27, and 310-10-50-31.

6 Leases involving real estate

Both lessees and lessors account for leases involving real estate according to their classification as capital, sales-type, direct financing or operating leases using their respective criteria. However, certain additional tests are necessary, and the land, building and equipment components of a lease are accounted for separately in some instances. The unique treatment of real estate in lease transactions is consistent with the accounting recognition that real estate is distinctive from equipment by its nature. As there are distinct rules for real estate sales transactions, there are also distinct rules for leases involving real estate and sale-leasebacks involving real estate (see Section 9). Also see Section 10 for a separate discussion of lessee involvement in asset construction.

6.1 Criteria for profit recognition under a sales-type lease of real estate

ASC 360-20, *Property, Plant, and Equipment – Real Estate Sales*, establishes standards for the recognition of profit on all real estate transactions without regard to the nature of the seller's business. In addition to containing dealer profit and transferring ownership by the end of the lease term, a lease must satisfy the requirements under ASC 360-20 for a full accrual sale to recognize dealer profit at the inception of the lease term. The following is a brief overview of the full accrual method.

Full accrual method

The full accrual method recognizes all of the profit when real estate is sold, provided that:

- ▶ The profit is determinable, and
- ▶ The earnings process is complete.

To determine when the requirements for the full accrual method have been satisfied, all of the following criteria must be met:

- ▶ A sale is consummated.
- ▶ The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property.
- ▶ The seller's receivable is not subject to future subordination.
- ▶ The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale, and does not have a substantial continuing involvement with the property sold (note, future profit participation is permitted).

Due to the restrictive criteria that must be met to qualify as a sale under the full accrual method (and the likelihood that many leases will not have a sufficient upfront payment by the lessee to demonstrate a commitment to pay for the property) many real estate lease transactions will not qualify as sales-type leases with immediate profit recognition. It is however, possible that the lease will qualify as a sales-type lease but profit recognition will be delayed and instead recognized under the installment, deposit or financing methods as described in ASC 360-20. See our Real estate sales FRD for further discussion of these methods.

6.2

Land only

Excerpt from Accounting Standards Codification**LESSEE****Leases – Overall***Recognition***840-10-25-37**

If land is the sole item of property leased and either the transfer-of-ownership criterion in paragraph 840-10-25-1(a) or the bargain-purchase-option criterion in paragraph 840-10-25-1(b) is met, the lessee shall account for the lease as a capital lease. Otherwise, the lessee shall account for the lease as an operating lease.

Leases – Capital Leases*Subsequent Measurement***840-30-35-2**

For a capital lease involving land only, because ownership of the land is expected to pass to the lessee if either the transfer-of-ownership criterion or bargain-purchase-option criterion is met, the asset recorded under the capital lease would not normally be amortized.

LESSOR**Leases – Overall***Recognition***840-10-25-55**

If the lease gives rise to manufacturer's or dealer's profit (or loss) and the transfer-of-ownership criterion in paragraph 840-10-25-1(a) is met, the lessor shall classify the lease as a sales-type lease and account for the transaction under the guidance in Subtopic 360-20 in the same manner as a seller of the same property.

840-10-25-56

If the lease does not give rise to manufacturer's or dealer's profit (or loss) and the transfer-of-ownership criterion in paragraph 840-10-25-1(a) and both criteria in paragraph 840-10-25-42 are met, the lessor shall account for the lease as a direct financing lease or a leveraged lease as appropriate.

840-10-25-57

If the bargain-purchase-option criterion in paragraph 840-10-25-1(b) and both criteria in paragraph 840-10-25-42 are met, the lessor shall account for the lease as a direct financing lease, a leveraged lease, or an operating lease as appropriate.

840-10-25-58

If the lease does not meet both of the criteria in paragraph 840-10-25-42, the lessor shall account for the lease as an operating lease.

840-10-25-59

The lease-term criterion in paragraph 840-10-25-1(c) and the minimum-lease-payments criterion in paragraph 840-10-25-1(d) do not apply to classifying land leases.

Leases – Operating**Recognition****840-20-25-21**

The guidance in this paragraph applies to an operating lease involving real estate that would have been classified by the lessor as a sales-type lease except that the lease did not meet the transfer-of-ownership criterion in paragraph 840-10-25-1(a). If, at the inception of such an operating lease, the fair value of the property is less than its cost (or carrying amount, if different), then a loss equal to that difference shall be recognized by the lessor at lease inception.

Lessee

A lease that transfers ownership of the land to the lessee by the end of the lease term or a lease that contains a bargain purchase option would be classified as a capital lease by the lessee. See Section 2.4 for further discussion regarding bargain purchase options. All other land leases are operating leases.

Lessor

A sales-type lease involving real estate must transfer title to the property by the end of the lease term. The lessor accounts for the sales-type lease in the same manner as a seller of the same property under ASC 360-20. A brief summary of gain recognition criteria under ASC 360-20 is included in Section 6.1.

If title is not transferred by the end of the lease term and the lease otherwise qualifies as a sales-type lease, the lessor would classify and account for the lease as an operating lease.

If the lease otherwise qualifies as a direct financing or leveraged lease because title is transferred by the end of the lease term or the lease contains a bargain purchase option (see Section 2.4), the lessor would classify and account for the lease as a direct financing or leveraged lease.

If the lease otherwise qualifies as a direct financing or leveraged lease, but title is not transferred by the end of the lease term and the lease does not contain a bargain purchase option, the lessor would classify and account for the lease as an operating lease. In other words, a lessor would not use the tests in ASC 840-10-25-1(c) or 25-1(d) (see Section 3.2) to classify a lease of land.

6.3**Land and buildings****Excerpt from Accounting Standards Codification****LESSEE****Leases – Overall****Recognition****840-10-25-38**

A lessee shall account for leases involving both land and building(s) as follows:

- a. If the lease meets either the transfer-of-ownership criterion in paragraph 840-10-25-1(a) or the bargain-purchase-option criterion in paragraph 840-10-25-1(b), 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 lease inception. If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of fair value of the leased property at lease inception for purposes of this paragraph.

- b. If the lease does not meet either the transfer-of-ownership criterion in paragraph 840-10-25-1(a) or the bargain-purchase-option criterion in paragraph 840-10-25-1(b):
1. If the fair value of the land is less than 25 percent of the total fair value of the leased property at lease inception, the lessee shall consider the land and the building as a single unit for purposes of applying the lease-term criterion in paragraph 840-10-25-1(c) and the minimum-lease-payments criterion in paragraph 840-10-25-1(d). For purposes of applying the lease-term criterion of paragraph 840-10-25-1(c), the estimated economic life of the building shall be considered as the estimated economic life of the unit. If either the lease-term criterion in paragraph 840-10-25-1(c) or the minimum-lease-payments criterion in paragraph 840-10-25-1(d) is met, the lessee shall capitalize the land and building as a single unit and amortize it in accordance with the guidance in paragraph 840-30-35-1(b), otherwise, the lease shall be accounted for by the lessee as an operating lease.
 2. If the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception, the lessee shall consider the land and the building separately for purposes of applying the lease-term criterion in paragraph 840-10-25-1(c) and the minimum-lease-payments criterion in paragraph 840-10-25-1(d). The minimum lease payments after deducting executory costs, including any profit thereon, applicable to the land and the building shall be separated by the lessee 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. The lessee shall account for the building and land elements as follows:
 - i. If the building element of the lease meets the lease-term criterion in 840-10-25-1(c) or the minimum-lease-payments criterion in paragraph 840-10-25-1(d), the building element shall be accounted for by the lessee as a capital lease and amortized in accordance with the guidance in paragraph 840-30-35-1(b). The land element of the lease shall be accounted for separately by the lessee as an operating lease.
 - ii. If the building element of the lease meets neither the lease-term criterion in 840-10-25-1(c) nor the minimum-lease-payments criterion in paragraph 840-10-25-1(d), both the building element and the land element shall be accounted for by the lessee as a single operating lease.

Leases – Capital Leases

Subsequent Measurement

840-30-35-3

For a capital lease involving both land and buildings, the building shall be amortized by the lessee in accordance with the guidance in paragraph 840-30-35-1(a); however, as stated in the preceding paragraph [see ASC 840-30-35-2 in Section 6.2], the land capitalized under a capital lease that meets either the transfer-of-ownership criterion or the bargain-purchase-option criterion would not normally be amortized.

LESSOR**Leases – Overall*****Recognition*****840-10-25-60**

Paragraph 360-20-40-56 provides guidance on accounting for a transaction in which a seller sells property improvements and leases the underlying land to the buyer of the improvements. Otherwise, the guidance on a lessor's classification of a lease involving both land and buildings is organized as follows:

- a. Lease meets transfer-of-ownership criterion
- b. Lease meets bargain-purchase-option criterion
- c. Lease does not meet either transfer-of-ownership criterion or bargain-purchase-option criterion.

Lease Meets Transfer-of-Ownership Criterion**840-10-25-61**

If the lease meets the transfer-of-ownership criterion in paragraph 840-10-25-1(a), the lessor shall classify and account for the lease as follows:

- 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 840-10-25-43(a) and account for the lease as a single unit under the guidance in Subtopic 360-20 in the same manner as a seller of the same property.
- b. If the lease does not give rise to manufacturer's or dealer's profit (or loss), the lessor shall classify and account for the lease as follows:
 1. If the lease meets both criteria in paragraph 840-10-25-42, the lessor shall account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 840-10-25-43(b) or 840-10-25-43(c).
 2. If the lease does not meet both criteria in paragraph 840-10-25-42, the lessor shall account for the lease as an operating lease.

Lease Meets Bargain-Purchase-Option Criterion**840-10-25-62**

If the lease meets the bargain-purchase-option criterion in paragraph 840-10-25-1(b), the lessor shall classify and account for the lease as follows:

- a. 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 840-10-25-43(d).
- b. If the lease does not give rise to manufacturer's or dealer's profit (or loss), the lessor shall classify and account for the lease as follows:
 1. If the lease meets both criteria in paragraph 840-10-25-42, the lessor shall account for the lease as a direct financing lease or a leveraged lease as appropriate under paragraph 840-10-25-43(b) or 840-10-25-43(c).
 2. If the lease does not meet both criteria in paragraph 840-10-25-42, the lessor shall account for the lease as an operating lease.

*Lease Does Not Meet Either Transfer-of-Ownership Criterion or Bargain-Purchase-Option Criterion***840-10-25-63**

If the lease does not meet either the transfer-of-ownership criterion in paragraph 840-10-25-1(a) or the bargain-purchase-option criterion in paragraph 840-10-25-1(b) and the fair value of the land is less than 25 percent of the total fair value of the leased property at lease inception, the lessor shall consider the land and the building as a single unit for purposes of applying the lease-term criterion in paragraph 840-10-25-1(c) and the minimum-lease-payments criterion in paragraph 840-10-25-1(d). For purposes of applying the lease-term criterion in paragraph 840-10-25-1(c), the estimated economic life of the building shall be considered as the estimated economic life of the unit.

840-10-25-64

If either the lease-term criterion in paragraph 840-10-25-1(c) or the minimum-lease-payments criterion in paragraph 840-10-25-1(d) and both criteria in paragraph 840-10-25-42 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 840-10-25-43.

840-10-25-65

If neither the lease-term criterion in paragraph 840-10-25-1(c) nor the minimum-lease-payments criterion in paragraph 840-10-25-1(d) are met or both criteria in paragraph 840-10-25-42 are not met, the lease shall be accounted for by the lessor as an operating lease.

840-10-25-66

If the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception, the lessor shall consider the land and the building separately for purposes of applying the lease-term criterion in paragraph 840-10-25-1(c) and the minimum-lease-payments criterion in paragraph 840-10-25-1(d).

840-10-25-67

The minimum lease payments after deducting executory costs, including any profit thereon, applicable to the land and the building shall be separated by 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.

840-10-25-68

If the building element of the lease meets either the lease-term criterion in paragraph 840-10-25-1(c) or the minimum-lease-payments criterion in paragraph 840-10-25-1(d) and both criteria in paragraph 840-10-25-42, the building element shall be accounted for by the lessor as a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph 840-10-25-43. The land element of the lease shall be accounted for separately by the lessor as an operating lease. If the building element of the lease meets neither the lease-term criterion in paragraph 840-10-25-1(c) nor the minimum-lease-payments criterion in paragraph 840-10-25-1(d) or does not meet both criteria in paragraph 840-10-25-42, both the building element and the land element shall be accounted for by the lessor as a single operating lease.

Lessee

A lease for land and buildings that transfers ownership to the lessee or contains a bargain purchase option (see Section 2.4) would be classified as a capital lease by the lessee. Lessees should capitalize the two components separately by allocating the minimum lease payments (see Section 2.9) in proportion to the components' fair value at the inception date (see Section 2.2). The building element is amortized using the lessee's depreciation policy for owned buildings. The land component would not normally be amortized.

If the lease does not transfer ownership to the lessee or contain a bargain purchase option, and the fair value of the land at the inception date represents 25% or more of the total fair value of the real property subject to the lease, the lessee must consider the land and building components separately when making the 75% of economic life and 90% of fair value tests for the building. If either of the tests is met, the land element would be classified as an operating lease and the building element as a capital lease by the lessee. The annual minimum lease payments applicable to the land component are determined by multiplying the fair value of the land by the lessee's incremental borrowing rate (see Section 2.11). The balance of the minimum lease payments (including the portion relating to residual value or first-loss guarantees) are attributed to the building component. The following example illustrates this concept:

Illustration 6-1: Allocating annual minimum lease payments between land and a building

- ▶ Land and a building are leased for a total annual rent of \$240,000, payable \$20,000 per month.
- ▶ Fair value of the land is \$600,000 and it is more than 25% of the combined fair value of the land and building.
- ▶ The lessee's incremental borrowing rate is 10%.

Because 10% of \$600,000 is \$60,000, that is the amount of the annual rent allocated to the land. The remaining \$180,000 is allocated to the building rent.

Leases involving land and buildings (land component less than 25%) would be treated as a single unit with the estimated economic life being the life of the building. When either the 75% or 90% test is met, the lessee accounts for the transaction as a capital lease. Otherwise, it is an operating lease.

Lessor – dealer profit

A sales-type lease involving real estate must transfer title to the property by the end of the lease term. The lessor then accounts for the sales-type lease in the same manner as a seller of the same property under ASC 360-20 (see Section 6.1).

If title is not transferred by the end of the lease term and the lease otherwise qualifies as a sales-type lease, the lessor would classify and account for the lease as an operating lease.

Lessor – no dealer profit

If the lease does not contain any dealer profit (i.e., cost is equal to fair value) and the lease transfers title to the lessee by the end of the lease term or contains a bargain purchase option (see Section 2.4) and meets the "collectibility of the minimum lease payments is reasonably predictable," and "no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease" criteria (see Section 3.3), the lessor classifies the lease of land and building as a direct financing or leveraged lease (if certain other criteria are met).

If the lease does not transfer title to the lessee by the end of the lease term and does not contain a bargain purchase option and the fair value of the land at the inception date (see Section 2.2) represents 25% or more of the total fair value, the lessor considers the land and building components separately when making the 75% of economic life and 90% of fair value tests for the building (lease payments for lessors are allocated the same as lease payments for lessees are allocated as illustrated above). As a result, the building component might qualify as a direct finance or leveraged lease but the land component would be classified as an operating lease. If the building component does not pass the 75% or 90% test, the land and building components would be treated as an operating lease.

All other combination land and building leases (land component less than 25%) where title is not transferred at the end of the lease term and the lease does not contain a bargain purchase option would be treated as a single unit with the estimated economic life being the life of the building. When either the 75% or 90% test is met, the lessor accounts for the transaction as a direct financing or leveraged lease. Otherwise, it is an operating lease.

6.3.1 Residual value or first loss guarantee

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-21

If the lessee provides a residual value guarantee in a lease of both land and building(s), and the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception, a question arises as to how the residual value guarantee shall be treated for purposes of performing the 90 percent test in paragraph 840-10-25-1(d).

840-10-25-22

Paragraphs 840-10-25-38(b)(2) and 840-10-25-67 state that the annual minimum lease payments applicable to the land are determined for both the lessee and lessor by multiplying the fair value of the land by the lessee's incremental borrowing rate. As a result, the remaining minimum lease payments, including the full amount of the residual value guarantee, are attributed to the building.

Leases of land and a building may also include a residual value or first-loss guarantee by the lessee of the leased land and building. Those guarantees are used by lessors as a means of transferring some of the risks in the property to the lessee and of ensuring that the lessor receives a return on and of its investment. Guarantees are included in minimum lease payments for purposes of determining the classification of the lease (ASC 840-10-25-6 – see Section 2.9). When a lease includes land and building(s), the annual minimum lease payments applicable to the land for both the lessee and lessor should be determined by multiplying the fair value of the land by the lessee's incremental borrowing rate (see Section 2.11). The remaining minimum lease payments, including the full amount of the guarantee, are attributed to the building. If however, the guarantee relates only to the land, and any surplus is not available to cover any decline in the building value, the guarantee should be included in minimum lease payments related to the land.

6.4 Real estate and equipment

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-19

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.

840-10-25-20

The equipment shall be considered separately for purposes of applying the lease classification criteria in paragraphs 840-10-25-1, 840-10-25-31, and 840-10-25-41 through 25-44 and shall be accounted for separately according to its classification by both lessees and lessors.

A lease encompassing real estate and equipment (except for integral equipment) requires allocating the minimum lease payments (see Section 2.9) to the equipment element in an amount which is estimated by whatever means are appropriate in the circumstances. The balance of the minimum lease payments is allocated to the land and building elements. The equipment component is accounted for in the same manner as any other equipment lease. The real estate elements are classified as described in Sections 6.2 and 6.3.

ASC 840 gives no guidance for estimating the lease payments applicable to equipment. The lease provisions and the substance of the transaction may provide sufficient information for determining the allocation basis. If 75% or more of the equipment's estimated economic life will have elapsed by the end of the lease term, title to the equipment transfers at the end of the lease or the equipment can be purchased at a bargain, the amount of the annual minimum lease payments applicable to the equipment might be determined by calculating the payment stream needed to amortize the equipment's fair value (present value) using the lessee's incremental borrowing rate (see Section 2.11). If the terms of the lease do not clearly indicate that the substance of the transaction is a sale of the equipment, it may be appropriate to allocate lease payments between the equipment and real estate portion of the lease based on their relative fair values.

See Section 6.4.1 for further guidance on evaluating whether equipment is integral equipment.

6.4.1 Leases of integral equipment

The phrase "all real estate sales" includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs (ASC 360-20-15-3). Examples include an office building, a manufacturing facility, a power plant or a refinery. ASC 360-20-15-3 further clarifies that integral equipment should be evaluated as real estate for purposes of applying the provisions of ASC 840.

Determining whether equipment constitutes "integral equipment" has taken on increased importance as that determination impacts the appropriateness of sales-type lease classification by lessors for leases involving equipment. In addition, that determination is important for reaching a conclusion under ASC 840-40 as to whether to apply the more stringent provisions for real estate sale-leaseback transactions rather than the sale-leaseback provisions pertaining to equipment.

The phrase “cannot be removed and used separately without incurring significant cost” contains two distinct concepts: (a) the ability to remove the equipment without incurring significant cost and (b) the ability of a different entity to use the equipment at another location without significant diminution in utility or value. The determination of whether equipment is integral equipment should be based on the significance of the cost to remove the equipment from its existing location (which would include the cost of repairing damage done to the existing location as a result of the removal), combined with the decrease in the value of the equipment as a result of that removal. At a minimum, the decrease in the value of the equipment as a result of its removal is the estimated cost to ship and re-install the equipment at a new site. The nature of the equipment, and the likely use of the equipment by other potential users, should be considered in determining whether any additional diminution in fair value exists beyond that associated with costs to ship and install the equipment. If there are multiple potential users of the leased equipment, the estimate of the fair value of the equipment as well as the costs to ship and install the equipment should assume that the equipment will be sold to the potential user that would result in the greatest net cash proceeds to the seller (current lessor). When the combined total of both the cost to remove plus the decrease in value, estimated at the lease’s inception (see Section 2.2), exceeds 10% of the fair value of the equipment (installed), at lease inception, the equipment is integral equipment (ASC 360-20-15-4 through 15-8). See Section 6.4.2 for discussion about lease accounting with integral equipment.

The following illustrates the integral equipment calculation:

(Costs incurred on removal, including repairs)	+	(The greater of loss in fair value upon removal or cost to ship and reinstall)	=	Total costs
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Equipment would be integral if:	Total costs	>	10% of fair value of equipment (installed) at inception of lease
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The following example illustrates:

Excerpt from Accounting Standards Codification

Property, Plant, and Equipment – Real Estate Sales

Implementation Guidance and Illustrations

360-20-55-58

Entity A leases equipment to Entity B for use in a manufacturing facility. The fair value of the production equipment (installed) at lease inception is \$1,075,000. The estimated cost to remove the equipment after installation (estimate is as of the beginning of the lease term) is \$80,000, which includes \$30,000 to repair damage to the existing location as a result of the removal. The estimated cost to ship and reinstall the equipment at a new site (estimated as of the beginning of the lease term) is \$85,000. For this Example, assume that the equipment would have the same fair value (installed) to the seller and a potential buyer. Therefore, there is no diminution in fair value of the equipment beyond the discount a purchaser would presumably require to cover the cost to ship and reinstall the equipment.

360-20-55-59

Entity A would assess whether or not the production equipment is integral equipment as follows: $(\$80,000 + \$85,000) \div \$1,075,000 = 15.3$ percent. Because the cost of removal combined with the diminution in value exceeds 10 percent of the fair value (installed) of the production equipment, the cost to remove the equipment and use it separately is deemed to be significant. Therefore, the production equipment is integral equipment.

6.4.2 Sales-type lease – integral equipment

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-46

To maintain conformity between the guidance in this Subtopic and Subtopic 840-40, integral equipment shall be evaluated by the lessor as real estate for purposes of this Topic (because Subtopic 360-20 defines integral equipment as real estate for purposes of that Subtopic).

840-10-25-47

For guidance on determining whether equipment is integral equipment, see paragraph 360-20-15-7.

840-10-25-48

For integral equipment or property improvements for which no statutory title registration system exists, the transfer-of-ownership criterion in paragraph 840-10-25-1(a) is met in leases that provide that, upon the lessee's performance in accordance with the terms of the lease, the lessor shall execute and deliver to the lessee such documents (including, if applicable, a bill of sale for the equipment) as may be required to release the equipment from the lease and to transfer ownership thereto to the lessee.

840-10-25-49

The transfer-of-ownership criterion is met also in situations in which the lease agreement requires the payment by the lessee of a nominal amount (for example, the minimum fee required by statutory regulation to transfer ownership) in connection with the transfer of ownership.

840-10-25-50

A provision in a lease agreement that ownership of the leased property is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer of ownership is a purchase option. Such a provision would not satisfy the transfer-of-ownership criterion in paragraph 840-10-25-1(a).

A lease involving real estate that gives rise to manufacturer's or dealer's profit must transfer ownership to the lessee by the end of the lease term in order to qualify for sales-type lease accounting (see Sections 6.2 and 6.3). Further, for lease accounting purposes, integral equipment should be evaluated as real estate. Accordingly, a lease of integral equipment or real estate with integral equipment would be accounted for as a sales-type lease only if it meets criterion ASC 840-10-25-1(a) (see Section 3.2) (i.e., transfer of ownership).

Questions often arise on how to apply the accounting provisions of ASC 840 requiring an ownership transfer to leases of integral equipment or leases of real estate with integral equipment in situations where a statutory title registration system does not exist for the leased asset.

Lessors must evaluate criterion ASC 840-10-25-1(a) as it applies to leases that give rise to manufacturer's or dealer's profit involving integral equipment or property improvements for which no statutory title registration system exists (e.g., fiber-optic cable that is considered integral equipment pursuant to the provisions of ASC 360-20). Criterion ASC 840-10-25-1(a) is considered to be met in lease agreements that provide that, upon the lessee's performance in accordance with the terms of the lease, the lessor shall execute and deliver to the lessee such documents (including, if applicable, a bill of sale for the equipment) as may be required to release the equipment from the lease and to transfer ownership to the lessee. This criterion is also met in situations in which the lease agreement requires the payment by the lessee of a nominal amount (e.g., the minimum fee required by statutory regulation to transfer ownership) in connection with the transfer of ownership. Notwithstanding the foregoing guidance, a provision in a lease

agreement that ownership of the leased property is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer of ownership is a purchase option. Such a provision would not satisfy criterion ASC 840-10-25-1(a) and would preclude sales-type lease accounting.

The provisions of ASC 840-10-25-46 through 25-50 described above were codified from EITF 00-11 and apply to lease transactions entered into after 19 July 2001 and to leases modified after that date that meet the criteria in ASC 840-10-35-4 (see Section 3.4) to be considered new lease agreements. Companies are required to disclose the effect on the balance sheet and the income statement resulting from a change in lease classification for leases modified after 19 July 2001 that at inception would have been classified differently had the guidance of ASC 840-10-25-46 through 25-50 been in effect at the inception of the original lease (paragraph 6 of EITF 00-11).

6.4.3 Indefeasible right of use

The granting of the right to use network capacity (e.g., conduit and fiber optic cables) is often referred to as an indefeasible right of use (IRU). Under an IRU agreement, an entity has the exclusive right to use a specified capacity. IRU agreements also are used in similar industries where “capacity” may be sold (e.g., oil pipelines).

The first issue is determining whether an IRU is a lease or a service contract. See Section 1.1 for guidance on determining whether an IRU is a lease or a service contract.

Once it has been determined that an IRU is a lease, the next step is determining whether the IRU involves integral equipment as defined in ASC 360-20 (see Section 6.4.1). In determining whether the fiber optic cable or an individual strand therein is integral equipment, the test referred to above in Section 6.4.1 is made.

If it is determined that the IRU relates to non-integral equipment the less onerous standards of classifying a lease of equipment as an operating, direct financing or sales-type lease by the lessor, as detailed in Section 5, may be followed. In addition, the sale-leaseback provisions for property other than real estate (see Section 8) rather than the sale-leaseback provisions for real estate (see Section 9) would apply in sale-leaseback situations. If it is determined that the IRU involves integral equipment, the next determination is whether the lease is a sales-type, direct financing or an operating lease.

If the lease of the IRU (determined to be an integral equipment lease) transfers ownership of the integral equipment at or near the end of the lease term, the lease of the integral equipment would be classified as a sales-type lease (see Section 6.4.2 for further details).

6.5 Leases involving only part of a building

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-23

If the leased property is part of a larger whole, its cost (or carrying amount) and fair value may not be objectively determinable (for example, 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 guidance for a lease involving both land and buildings. For purposes of applying the guidance in this paragraph to leases involving only part of a building, other evidence may provide a basis for an objective determination of fair value even if there are no sales of property similar to the leased property. For example, reasonable estimates of the leased property's fair value might be objectively determined by referring to an independent appraisal of the leased property or

to estimated replacement cost information. Similarly, although replacement cost will not reflect the fair value of the leased property in all circumstances, if the leased facility has been recently constructed or acquired, cost estimates may provide a reasonable basis for estimating the property's fair value for purposes of applying the minimum-lease-payments criterion in paragraph 840-10-25-1(d).

840-10-25-24

With respect to the guidance in the preceding paragraph, this Subtopic does not impose a requirement to obtain an appraisal or similar valuation as a general matter but that kind of information should be obtained whenever possible if both of the following conditions exist:

- a. Classification as a capital lease seems likely.
- b. The effects of capital lease classification would be significant to the financial statements of a lessee.

840-10-25-39

Unless both the cost and the fair value of the leased property are objectively determinable (as discussed in paragraph 840-10-25-23), a lease involving only part of a building shall be classified and accounted for by the lessee as follows:

- a. If the fair value of the leased property is objectively determinable, the lessee shall classify and account for the lease according to the guidance in paragraph 840-10-25-38.
- b. If the fair value of the leased property is not objectively determinable, the lessee shall classify the lease according to the lease-term criterion in paragraph 840-10-25-1(c) only, using the estimated economic life of the building in which the leased premises are located. If the lease-term criterion is met, the leased property shall be capitalized as a unit and amortized in accordance with the guidance in paragraph 840-30-35-1(b).

840-10-25-69

If either the cost or the fair value of the property is not objectively determinable (as discussed in paragraph 840-10-25-23), the lessor shall classify and account for a lease involving only part of a building as an operating lease.

When leased property is part of a larger whole (e.g., one floor in an office building or one store in a shopping center), its cost (or carrying amount) and fair value may not be objectively determinable. If a lessee cannot objectively determine the fair value of the portion of the property it leases, the 90% of fair value criterion cannot be applied and the only applicable criterion for capital lease classification is the 75% of economic life test. Because most leases involving only part of a building have terms of less than 75% of the economic life of the building, generally such leases are classified as operating leases. If a lessor cannot objectively determine the cost or fair value of the portion of the property being leased, the lessor should account for the lease as an operating lease.

As discussed in Section 2.3, fair value is the selling price in an arm's-length transaction between unrelated parties. Some have questioned whether fair value can be objectively determined for a lease involving only part of a building if there are no sales of property similar to the leased property to use as a basis for estimating the leased property's fair value. Reasonable estimates of a leased property's fair value might be objectively determinable from other information if sales of property similar to the leased property do not exist. Therefore, it should not automatically be assumed that a lease of property which is part of a larger whole (e.g., retail stores and offices) would be classified as an operating lease.

In many cases, fair value could be determined and the contention that there are no sales of similar property is not sufficient justification for classifying a lease as operating. Other evidence might provide a basis for an objective determination of fair value; for example, an independent appraisal of the leased property or estimated replacement cost information.

There is no requirement to obtain an appraisal or similar valuation. However, if (a) classification as a capital lease seems likely and (b) the effects of capital lease classification would be significant to the financial statements of the lessee, an appraisal or similar valuation should be obtained whenever possible. Further, although this guidance applies to all leases, the size of the leased property in relation to the entire facility should be considered. If the portion leased does not represent a significant portion of the facility, it is unlikely that a meaningful appraisal is obtainable. In contrast, if a significant portion of a building is leased, objective evidence might be available to support a fair value determination. With respect to leases involving only part of a building, it is rare that any portion of the lease payments is ascribed to the land.

6.6

Leases of property from a governmental unit

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-25

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. Because 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 shall also be classified as operating leases. Examples of such leases may be those involving facilities at ports and bus terminals. The guidance in this paragraph is intended to apply to leases only if all of the following conditions are met:

- a. The leased property is owned by a governmental unit or authority.
- b. The leased property is part of a larger facility, such as an airport, operated by or on behalf of the lessor.
- c. The leased property is a permanent structure or a part of a permanent structure, such as a building, that normally could not be moved to a new location.
- d. The lessor, or in some circumstances a higher governmental authority, has the explicit right under the lease agreement or existing statutes or regulations applicable to the leased property to terminate the lease at any time during the lease term, such as by closing the facility containing the leased property or by taking possession of the facility.
- e. The lease neither transfers ownership of the leased property to the lessee nor allows the lessee to purchase or otherwise acquire ownership of the leased property.
- f. The leased property or equivalent property in the same service area cannot be purchased nor can such property be leased from a nongovernmental unit or authority. Equivalent property in the same service area is property that would allow continuation of essentially the same service or activity as afforded by the leased property without any appreciable difference in economic results to the lessee.

Leases of property not meeting all of the conditions in paragraph 840-10-25-25 are subject to the same criteria for classifying leases under this Subtopic that are applicable to leases not involving government owned property.

Arrangements for the use of property owned by a governmental unit may meet the definition of a service concession arrangement that is within the scope of ASC 853, *Service Concession Arrangements*. See Section 1.12 for information on service concession arrangements.

7 Related parties and variable interest entities

7.1 Leases with related parties

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-26

Except as noted in the following sentence, leases between related parties (see paragraph 840-10-55-27) shall be classified in accordance with the lease classification criteria in paragraphs 840-10-25-1, 840-10-25-31, and 840-10-25-41 through 25-44. 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 circumstances in which 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 circumstances the classification and accounting shall be modified as necessary to recognize economic substance rather than legal form.

Implementation Guidance and Illustrations

840-10-55-27

Provided that the parent entity, owner entity, or investor has the ability to exercise significant influence over operating and financial policies of the related party, all of the following are related parties in leasing transactions:

- a. A parent company and its subsidiaries
- b. An owner company and its joint ventures (corporate or otherwise) and partnerships
- c. An investor (including a natural person) and its investees.

840-10-55-28

In addition to the examples of significant influence set forth in paragraph 323-10-15-6, significant influence may be exercised through any of the following:

- a. Guarantees of indebtedness
- b. Extensions of credit
- c. Ownership of warrants (call options)
- d. Debt obligations
- e. Other securities.

840-10-55-29

If two or more entities are subject to the significant influence of a parent, owner entity, investor (including a natural person), or common officers or directors, those entities shall be considered related parties in leasing transactions with respect to each other.

Other Presentation Matters**840-10-45-1**

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 entities 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 entity.

Disclosures**840-10-50-1**

The nature and extent of leasing transactions with related parties shall be disclosed.

Relationships**840-10-60-4**

For guidance on the identification of implicit variable interests, see the guidance beginning in paragraph 810-10-25-48. Example 4 (paragraph 810-10-55-87) illustrates the application of that guidance to a leasing entity that is a variable interest entity.

Pending Content:

Transition Date: December 15, 2015 | Transition Guidance: 810-10-65-4

Editor's note: The content of paragraph 840-10-60-4 will change upon adoption of ASU 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangments. For private companies that elect the alternative, ASU 2014-07 is effective for annual periods beginning after December 15, 2014 and interim periods within annual periods beginning after December 15, 2015. Early adoption is permitted for any annual or interim period for which an entity's financial statements have not yet been made available for issuance.

840-10-60-4

For guidance on the identification of implicit variable interests, see the guidance beginning in paragraph 810-10-25-49.

Examples of related-party leases that might not be accounted for according to form are:

1. A short-term lease of a special-purpose asset for which there is no likely alternative use; and
2. A short-term lease of an asset when (a) the lessee's business requires the leased asset to be used for an extended period of time, (b) lease payments are based on long-term leasing rates and (c) payments for a period longer than the stated lease term are needed to fund leasing-related external obligations of the lessor.

In either of the above circumstances, consideration should be given to classifying and accounting for the lease on the basis of a realistic lease term.

See our Consolidation of variable interest entities FRD for a discussion of related party leases including the consideration of the potential impact of implicit variable interests.

7.1.1**Leases involving variable interest entities**

ASC 810 includes provisions related to the consolidation of certain entities that have (1) an insufficient amount of equity for the entity to finance its activities without additional subordinated financial support provided by any parties, (2) a group of equity owners that do not have the power to direct the entity's activities that most significantly impact the entity's economic performance or (3) equity that does not absorb the entity's losses or receive the entity's benefits. Please see our Consolidation of variable interest entities FRD for further guidance.

8 Sale-leaseback not involving real estate

This Section deals with the sale and leaseback of tangible personal property, while the next section, Section 9, deals with the sale and leaseback of real property and integral equipment (referred to as “real estate” for purposes of sale-leaseback accounting). Guidance in this Section is also applicable to real property (i.e., real estate and integral equipment) unless specifically excluded. Real property includes real estate, including real estate with equipment, such as manufacturing facilities, power plants and office buildings with furniture and fixtures as well as integral equipment and certain stand-alone equipment as specified in Section 9. See Section 6.4 for further discussion of what constitutes real estate, including intergral equipment.

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Overview and Background

840-40-05-3

Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller.

Recognition

840-40-25-2

If a sale of property is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life and the lease meets one of the four lease classification criteria in paragraph 840-10-25-1, the seller-lessee shall account for the lease as a capital lease. Otherwise, the seller-lessee shall account for the lease as an operating lease.

840-40-25-3

Any profit or loss on the sale shall be deferred, unless any of the following conditions exist:

- 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. In that circumstance, 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 lease inception, an appropriate amount shall be deferred or accrued by adjusting the profit or loss on the sale to adjust those rentals to a reasonable amount.
- b. The seller-lessee retains more than a minor part but less than substantially all of the use of the property through the leaseback and realizes a profit on the sale in excess of whichever of the following two amounts applies:
 1. If the leaseback is classified as an operating lease, the present value of the minimum lease payments over the lease term, computed using the interest rate that would be used to apply the minimum-lease-payments criterion in paragraph 840-10-25-1(d)
 2. If the leaseback is classified as a capital lease, the recorded amount of the leased asset.

In that circumstance, the profit on the sale in excess shall be recognized at the date of the sale.
- c. The fair value of the property at the time of the transaction is less than its undepreciated cost, in which circumstance a loss shall be recognized immediately.

840-40-25-4

If the seller-lessee retains, through a leaseback, substantially all of the benefits and risks incident to the ownership of the property sold, the sale-leaseback transaction is merely a financing. The seller-lessee shall not recognize any profit on the sale of an asset if the substance of the sale-leaseback transaction is merely a financing. Accordingly, this Subtopic does not permit any profit to be recognized on a sale if a related leaseback of the entire property sold meets one of the criteria in paragraph 840-10-25-1 for classification as a capital lease. A lessee shall defer any profit realized by the lessee during the construction period (for example, rental income paid to the lessee during the construction period under a ground lease or fees paid for construction or development services) in those transactions. In addition, an entity that may become the lessee as a result of the exercise of an option following construction completion shall defer any profit realized during the construction period.

840-40-25-5

If the fair value of the asset sold is more than its carrying amount, any indicated loss on the sale is probably in substance a prepayment of rent, and thus, the entity shall defer that indicated loss as prepaid rent.

Initial Measurement**840-40-30-2**

The amount recognized under paragraph 840-40-25-3(b) shall be measured as 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.

840-40-30-3

The loss amount recognized under paragraph 840-40-25-3(c) shall be measured up to the amount of the difference between undepreciated cost and fair value.

Subsequent Measurement**840-40-35-1**

Any profit or loss on the sale deferred under paragraph 840-10-25-3 shall be amortized as follows:

- a. If the leased asset is land only, straight-line over the lease term
- b. If the leased asset is not land only:
 1. If a capital lease, in proportion to the amortization of the leased asset
 2. If an operating lease, in proportion to the related gross rental charged to expense over the lease term.

840-40-35-2

Any amount deferred or accrued under paragraph 840-40-25-3(a) shall be amortized as specified in the preceding paragraph.

840-40-35-3

Any profit deferred under paragraph 840-40-25-4 shall be amortized to income in a manner similar to what is prescribed in paragraphs 840-40-55-26 through 55-28.

840-40-35-4

Any indicated loss on the sale deferred as prepaid rent under paragraph 840-40-25-5 shall be amortized over the lease term.

8.1 Seller-lessee accounting

A sale-leaseback transaction involves the sale of an asset and leaseback of the same asset by the seller. In most sale-leaseback transactions, profit or loss on the sale is deferred and amortized prospectively over the term of the lease in proportion to the amortization of the leased asset, if a capital lease, or in proportion to the related gross rental charged to expense over the lease term (see Section 2.6), if an operating lease. If a purchase option was determined not to be a bargain at the inception of a sale-leaseback but during the term it becomes probable that the purchase option would be exercised, any unamortized profit would be amortized prospectively over the useful life of the asset (although when the purchase option is exercised, any balance outstanding for the deferred profit would be recorded as an offset to the purchase price).

In the following situations, the seller-lessee is required to recognize some of the profit on sale:

- ▶ If the seller-lessee retains only a minor portion of the property or a minor part of its remaining useful life through the leaseback, the sale and leaseback are accounted for as separate transactions based on their respective terms. However, if the rentals under the lease agreement are unreasonable in relation to market conditions at the inception of the lease, an appropriate amount is deferred or accrued (by adjusting the profit or loss on the sale) and amortized as an adjustment of those rentals. See Section 8.1.3 for a discussion of reasonable lease payments.
- ▶ If the seller-lessee retains the use of more than a minor portion of the property, but less than substantially all of it, and the profit on the sale exceeds the present value of the minimum lease payments (see Section 2.9) due under the leaseback (for an operating lease) or the recorded amount of the leased asset (for a capitalized lease), that excess is recognized as profit at the date of sale. The seller-lessee is presumed to have retained “substantially all” of the remaining use of the property sold if the leaseback of the entire property sold meets the criteria for classification as a capital lease.

See Section 8.1.2 for further discussion of the meaning of minor and substantially all. See Sections 8.1.1 and 8.1.2 for illustrations of sale-leaseback profit recognition for property other than real estate when the seller-lessee retains more than a minor portion of the property or a minor part of its remaining useful life through the leaseback.

If the fair value of the property at the time of the transaction is less than its undepreciated cost, a loss shall be recognized immediately up to the amount of the difference between undepreciated cost and fair value. If multiple assets are sold to the same lessor at or about the same time at a gain, the fair value (not the sales price) and carrying amount of each asset sold should be evaluated to determine whether there is an indicated loss. If the fair value of any individual asset at the time of the transaction is less than that asset’s undepreciated cost, a loss should be recognized immediately for the difference between undepreciated cost and fair value. The loss should not be netted against the gain deferred or recognized on the other assets sold and leased back.

8.1.1 Sale-leaseback profit recognition – illustrations

The following illustrations are derived from examples in ASC 840-40-55-89 through 55-94 and demonstrate profit recognition in a sale-leaseback for property other than real estate when the seller-lessee retains more than a minor portion of the property:

Illustration 8-1: Leasebacks that are not minor but do not cover substantially all of the use of the property sold

An enterprise sells an airplane with an estimated remaining economic life of 10 years. At the same time, the seller leases back the airplane for three years. Pertinent data are:

Sales price	\$ 600,000
Carrying value of airplane	100,000
Monthly rental under leaseback	6,330
Interest rate implicit in the lease as computed by the lessor	12%

The leaseback does not meet any of the criteria for classification as a capital lease; hence, it would be classified as an operating lease. The seller-lessee would compute the profit to be recognized on the sale as follows:

Profit on the sale	\$ 500,000
Present value of operating lease rentals (\$6,330 for 36 months at 12%)	<u>190,581</u>
Profit to be recognized	<u>\$ 309,419</u>

The \$190,581 deferred profit (the difference between \$500,000 total profit and the \$309,419 of profit recognized) would be amortized in equal monthly amounts over the lease term because the leaseback is classified as an operating lease.

Illustration 8-2: Leasebacks that cover substantially all of the use of the property sold

An enterprise sells equipment with an estimated remaining economic life of 15 years (assumed that equipment is not in the last 25% of its useful life). At the same time, the seller leases back the equipment for 12 years. All profit on the sale would be deferred and amortized in relation to the amortization of the leased asset because the leaseback of all of the property sold covers a period in excess of 75% of the remaining economic life of the property, and thus, meets one of the criteria of ASC 840-10-25-1 (see Section 3.2) for classification as a capital lease. Because the property leaseback is for substantially all of its remaining economic life, the total profit is subject to deferral. Thus, even if the profit exceeded the present value of the minimum payments due under the lease, no amounts could be recognized immediately.

8.1.2**Seller-lessee retains only a minor portion of the property****Excerpt from Accounting Standards Codification****Minor**

When the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold.

Substantially All

In the context of the concepts underlying the classification criteria of Topic 840, a test based on the 90 percent recovery test in the minimum-lease-payments criterion in paragraph 840-10-25-1(d) could be used as a guideline. That is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee would be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold. In contrast, if a leaseback of the entire property sold meets the criteria of Topic 840 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.

A test based on the 90% criterion used in ASC 840-10-25-1(d) (see Section 3.2) could be used as a guideline to distinguish a “minor” leaseback. Thus, if the present value of minimum lease payments (presumed to be reasonable – Section 8.1.3) for the leaseback is less than 10% of the fair value of the asset sold, the leaseback could be presumed to be “minor.” The determination of whether the present value of minimum lease payments is minor is made using the interest rate utilized for purposes of the 90% test. Much of the guidance for sale-leaseback transactions not involving real estate in ASC 840-40 was codified from Statement 28. In the basis for conclusions for Statement 28, the FASB indicated that it was severely limiting the minor leaseback exception to prevent recognition of profit on what are in-substance financing transactions (paragraph 11 of Statement 28).

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

Example 6: Leaseback of Equipment That Is Minor

840-40-55-81

This Example illustrates application of the guidance in paragraph 840-40-25-3.

840-40-55-82

An entity sells equipment. The equipment is not integral equipment and has an estimated remaining life of approximately 25 years. The seller negotiates a leaseback of the equipment for one year because the seller has ordered replacement equipment that is expected to be available for the seller to use in approximately one year. This Example has the following assumptions.

Contractually stated sales price	\$ 20,000,000
Carrying value of equipment	\$ 6,000,000
Annual rental under leaseback	\$ 800,000
Estimated value of annual market rental	\$ 1,800,000
Appraised value of equipment	\$ 21,000,000

840-40-55-83

The leaseback is a minor leaseback because the present value of the leaseback (\$1,800,000) is less than 10 percent of the fair value of the asset sold (\$21,000,000). Accordingly, the seller-lessee would record the sale and would recognize profit. An amount of \$1,000,000 (\$1,800,000 less \$800,000) would be deferred and amortized as additional rent expense over the term of the leaseback to adjust the leaseback rentals to a reasonable amount. Accordingly, the seller-lessee would recognize \$15,000,000 as profit on the sale (\$14,000,000 of profit based on the terms of the sale increased by \$1,000,000 to adjust the leaseback rentals to a reasonable amount).

840-40-55-84

If the term of a prepayment of rent were significant, the amount deferred would be the amount required to adjust the rental to the market rental for equivalent equipment if that rental were also prepaid.

8.1.3 Determining fair value and reasonable lease payments

In performing the comparison of the present value of the lease payments under a leaseback to the fair value of the asset that was sold, it is imperative that the lease payments and the fair value of the asset are reasonable. Due to the nature of a sale-leaseback transaction (essentially a financing), the sales price does not necessarily indicate fair value of the asset sold nor do the underlying lease payments automatically indicate a market rent. In many cases, it will be necessary to adjust the net cash flows (cash received on the sale and cash paid under the lease agreement) to determine the fair value of the asset and a reasonable rental payment.

Illustration 8-3: Sale-leaseback for which sales price and lease payments are not at fair value/market rent

Company A sells a truck with a net book value of \$110 (and original cost of \$120) to a third party for \$130 and leases it back under a 1-year leaseback with annual rent of \$20. Assuming the fair value of the truck was \$118 at the date of sale and a reasonable annual rent would have been \$8, to determine whether the leaseback covers a minor portion of the property or substantially all (or some amount in between), the present value of the \$8 of reasonable lease payment should be compared to the fair value of the truck sold of \$118. In this instance a comparison of the present value of reasonable lease payments to the fair value of the truck indicates the leaseback is minor. Accordingly, the gain that is recognized is based on a sales price of \$118 less net book value of \$110, in this case \$8.

8.1.4 Executory costs effect on sale-leaseback accounting

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Initial Measurement

840-40-30-5

Executory costs (such as insurance, maintenance, and taxes) of property leased in a sale-leaseback transaction may be paid through one of the following arrangements:

- a. Paid by the buyer-lessor who expects to recover the costs through the monthly rentals established in the lease
- b. Paid by the buyer-lessor and in turn billed to the seller-lessee as an addition to the rent
- c. Paid directly by the seller-lessee.

840-40-30-6

Executory costs of the leaseback shall be excluded from the calculation of profit to be deferred on a sale-leaseback transaction irrespective of who pays the executory costs or the classification of the leaseback.

Executory costs (such as insurance, maintenance, costs of obtaining a third party residual value guarantee and taxes) of property leased in a sale-leaseback transaction (1) may be paid by the buyer-lessor that expects to recover the costs through the monthly rentals established in the lease, (2) may be paid by the buyer-lessor and in turn billed to the seller-lessee as additional rent or (3) may be paid directly by the seller-lessee. Executory costs of the leaseback should be excluded from the calculation of profit to be deferred on a sale-leaseback transaction regardless of which entity pays the executory costs or the classification of the leaseback.

8.1.5 Sale and leaseback of an asset that is subject to an operating lease

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-22

An entity enters into a sale and leaseback of an asset that meets either of the following criteria:

- a. The asset is subject to an operating lease.
- b. The asset is subleased or intended to be subleased by the entity to another party under an operating lease.

840-40-55-23

The transaction involves personal property that is not within the scope of the Real Estate Subsections of this Subtopic. In the transaction, the entity becomes the seller-lessee-sublessor, leasing the property from a third party and subletting it to an end user, all under operating leases.

840-40-55-24

The seller-lessee-sublessor should account for the transaction as a sale-leaseback in accordance with paragraphs 840-40-25-2 through 25-3, 840-40-30-1 through 30-3, and 840-40-35-1 through 35-2. That is, the seller-lessee-sublessor records the sale, removes the asset from its balance sheet, and classifies the leaseback in accordance with paragraph 840-10-25-43. Any gain on the transaction should be recognized or deferred and amortized in accordance with paragraph 840-40-25-3.

The guidance above addresses transactions involving a sale-leaseback of an asset that is either (1) subject to an operating lease or (2) subleased or intended to be subleased by the lessee to another party under an operating lease. The transaction involves personal property that is not considered real estate property (see Section 9 for accounting for sale-leasebacks of real estate). In the transaction, the seller-lessee-sublessor leases the property from the buyer and subleases it to an end user.

The seller-lessee-sublessor should account for the transaction as a sale-leaseback as opposed to a borrowing. That is, the seller-lessee-sublessor records the sale, removes the asset from its balance sheet, and classifies the leaseback as a capital or operating lease as appropriate based on its terms. Any gain on the transaction should be recognized or deferred and amortized in accordance with the provisions of sale-leaseback accounting as detailed in Section 8.1. The sublease terms may, however, impact the leaseback classification as capital or operating. See Section 2.6.2 for further details.

8.1.6 Deferred profit on sale-leaseback transaction with lessee guarantee of residual value

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-26

The seller-lessee may guarantee to the lessor that the residual value will be a stipulated amount at the end of the lease term. The seller-lessee retains more than a minor part but less than substantially all the use of the property through the leaseback. The lease does not meet the criteria for classification as a capital lease.

840-40-55-27

The seller-lessee should defer profit equal to the present value of the periodic rents plus the gross amount of the guarantee at the date of sale. The amount of deferred profit equal to the gross guarantee should be deferred until the guarantee is resolved at the end of the lease term.

840-40-55-28

The remaining deferred profit, equal to the present value of the periodic rents, should be amortized in relation to gross rent expense over the lease term.

In a sale-leaseback transaction coupled with a seller guarantee of the non-real estate asset's residual value in which the seller-lessee retains more than a minor part but less than substantially all the use of the property through the leaseback, profit equal to the present value of the periodic rents plus the gross amount of the guarantee should be deferred at the date of sale. The amount of deferred profit equal to the gross guarantee should be deferred until the guarantee is resolved, generally at the end of the lease term. The remaining deferred profit, if any, equal to the present value of the periodic rents, should be amortized in relation to gross rent expense over the lease term.

Due to the fact that the seller-lessee includes the guarantee in the amount of the profit deferred at the date of the sale, no additional accounting for the guarantee is required under ASC 460, *Guarantees*, if the guarantee is an impediment to profit recognition.

8.1.7 **Asset sold is different than the asset leased back**

In certain sale-leaseback transactions, the asset sold is not the same as the asset leased back. In considering such transactions, we believe that despite the fact that the assets sold and leased back are different, the transaction should be recorded as a sale-leaseback if the sale and lease were entered into as part of a single transaction and the assets involved would be required to be accounted for as a nonmonetary exchange under ASC 845, *Nonmonetary Transactions*, if they had been exchanged.

8.1.8 **Lease-leaseback transactions (LILO's)**

In a lease transaction where the owner of an asset leases an asset to a third party and then leases it back (under an operating or capital lease) the question often arises as to whether the transaction should be accounted for as a sale-leaseback. Transactions of this type are often tax driven (see also Section 11). Lease-leaseback transactions should be assessed in consideration of the guidance in ASC 840-10-15-16 (see Section 1.1.5) which requires that separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement. That is, both the original lease out of the asset from the owner to the third party and the leaseback from the third party to the owner should be evaluated concurrently. Often this evaluation results in the determination that a lease does not exist (i.e., in substance a financing recorded on the balance sheet) as the right to use the property is not conveyed from the owner to the third party when both the original lease out and the leaseback are considered a single arrangement.

8.1.9 **Accounting for the sale of property subject to the seller's preexisting lease**

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-37

An entity owns an interest in property and also is a lessee under an operating lease for all or a portion of the property. Acquisition of an ownership interest in the property and consummation of the lease occurred at or near the same time. This owner-lessee relationship can occur, for example, when the

entity has an investment in a partnership that owns the leased property. The entity subsequently sells its interest or the partnership sells the property to an independent third party and the entity continues to lease the property under the preexisting operating lease.

840-40-55-38

A transaction should be considered a sale-leaseback transaction subject to this Subtopic if the preexisting lease is modified in connection with the sale, except for insignificant changes. Accordingly, transactions with modifications to the preexisting lease involving real estate should be accounted for in accordance with the guidance in this Subtopic that addresses sale-leaseback transactions involving real estate. If the preexisting lease is not modified in conjunction with the sale, except for insignificant changes, profit should be deferred and recognized in accordance with paragraph 840-40-25-3.

840-40-55-39

Irrespective of lease modifications, the calculation of the amount of deferred profit should not be affected by the seller-lessee's prior ownership percentage in the property.

840-40-55-40

The exercise of a renewal option for a period that was included in the original minimum lease term or a sublease provision contained in the preexisting lease, does not affect the accounting for the transaction. However, the exercise of a renewal option for a period that was not included in the original lease term is a new lease, and the guidance in this Subtopic should be applied.

840-40-55-41

A lease between parties under common control should not be considered a preexisting lease. Accordingly, the guidance in this Subtopic should be applied to transactions that include property within its scope, except if Topic 980 applies. That is, if one of the parties under common control is a regulated entity with a lease that has been approved by the appropriate regulatory agency, that lease should be considered a preexisting lease.

When developing the above guidance for the sale of property subject to the seller's pre-existing lease, the EITF did not address the accounting when the acquisition of the ownership interest in the property and the consummation of the lease did not occur at or near the same time (EITF 88-21). The greater the period of time that elapses between the purchase of the property and the entering into of a leaseback of the property, the greater the likelihood that the purchase and lease should be accounted for as separate transactions.

8.1.10

Wrap lease transactions

Excerpt from Accounting Standards Codification

Wrap Lease Transaction

A transaction in which an entity purchases an asset, leases the asset to a lessee, obtains nonrecourse financing using the lease rentals or the lease rentals and the asset as collateral, sells the asset subject to the lease and the nonrecourse debt to a third-party investor, and leases the asset back while remaining the substantive principal lessor under the original lease.

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-17

If the property involved in a wrap lease transaction is real estate, the guidance in this Subtopic relating specifically to transactions involving real estate applies to the sale-leaseback transaction.

840-40-55-18

If the property involved is not real estate, the entity should account for the transaction as a sale-leaseback transaction in accordance with paragraphs 840-40-25-2 through 25-3, 840-40-25-8, 840-40-30-1 through 30-3, and 840-40-35-1 through 35-2, and the lease to the end user should be accounted for as a sublease in accordance with paragraph 840-10-35-10.

840-40-55-19

Under this Subtopic the asset should be removed from the books of the original entity, the leaseback should be classified in accordance with paragraph 840-10-25-43, and any gain on the transaction should be recognized or deferred and amortized in accordance with paragraph 840-40-25-3.

840-40-55-20

The entity would also reflect the retained residual interest, gross sublease receivable, nonrecourse third-party debt, the leaseback obligation, and the note receivable from the investor in the statement of financial position.

840-40-55-21

The sublease asset and the related nonrecourse debt should not be offset in the statement of financial position unless a right of setoff exists.

The following is a summary of a transaction commonly referred to as a wrap lease transaction: A company purchases an asset, leases the asset to a lessee (under either a capital or operating lease), obtains non-recourse financing using the lease rentals or the lease rentals and the asset as collateral, sells the asset subject to the lease and the non-recourse debt to a third-party investor, and leases the asset back (under a capital or operating lease) while remaining the substantive principal lessor under the original lease.

If the property involved is real estate, the accounting provisions under ASC 840-40 for real estate sale-leaseback transactions apply (see Section 9). If the property involved is not real estate, the enterprise should account for the transaction as a sale-leaseback transaction in accordance with the referenced paragraphs of ASC 840-40 (see Section 8), and the lease to the end user should be accounted for as a sublease in accordance with ASC 840-10-35-10 (see Section 12.2). The asset should be removed from the books of the company, the leaseback should be classified in accordance with ASC 840-10-25 as a capital or operating lease and any gain on the transaction should be recognized or deferred and amortized in accordance with the provisions of sale-leaseback accounting. The company also should reflect the retained residual interest, gross sublease receivable, non-recourse third-party debt, the leaseback obligation and the note receivable from the investor in the statement of financial position. As in accounting for a money-over-money lease transaction (see Section 14.2.11), the leaseback and the related non-recourse debt should not be offset in the statement of financial position unless a right of setoff exists.

8.1.11**Transfer of a purchase option by a lessee**

A frequent transaction involves the transfer of a purchase option under an operating lease, by a lessee, to a third party (that may be a substantive entity or a special purpose entity – see Section 7.1.1) that exercises the purchase option and leases the property to the same lessee. In our view, if the lessee does not enter the chain of ownership and the fair value of the purchase option is less than 10% of the fair value of the leased property, we do not believe the transaction should be accounted for as a sale-leaseback. If however, the lessee exercises the purchase option, thereby entering the chain of ownership, we would view the transaction as a sale-leaseback. In addition, if the fair value of the purchase option exceeds 10% of the fair value of the leased asset, we would also view the transaction as a sale-leaseback since the value transferred to the new lessor is significant.

8.1.12 Modification of a capital lease

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Scope and Scope Exceptions

840-40-15-6

Except in the circumstances discussed in paragraph 840-30-35-10, if a change in the provisions of a capital lease gives rise to a new agreement classified as an operating lease, the transaction shall be accounted for under the sale-leaseback requirements of this Subtopic.

ASC 840-40-15-6 requires lessees to apply sale-leaseback accounting guidance to modifications of capital lease arrangements that give rise to a new arrangement which is classified as an operating lease. Consequently, when a capital lease is terminated or modified and in conjunction with the termination or modification the lessee enters into an operating lease with the lessor, the applicable provisions for sale-leaseback transactions in ASC 840-40-25 would govern the amount of gain or loss to be recognized (or deferred) by the lessee as a result of the termination of the capital lease. If the leased assets are real estate and/or integral equipment, the more onerous provisions related to sale-leasebacks of real estate would apply (see Section 9). Note that this requirement does not apply to certain changes in the provisions of a lease that result from a refunding by the lessor of tax-exempt debt (see Section 4.2.5).

8.2 Buyer-lessor accounting

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Recognition

840-40-25-8

If a lease meets the criteria in paragraphs 840-10-25-1 and 840-10-25-42, the purchaser-lessor shall record the transaction as a purchase and a direct financing lease; otherwise, the purchaser-lessor shall record the transaction as a purchase and an operating lease.

The sale-leaseback rules do not impact the purchaser's/lessor's accounting for the transaction. A purchaser/lessor involved in a sale-leaseback transaction accounts for the transaction as the acquisition of an asset and a corresponding finance or operating lease out. In addition, the purchaser/lessor in a sale-leaseback may also account for the lease as a leveraged lease if the appropriate requirements of leveraged lease accounting have been met (see Section 14).

Sale and leaseback involving real estate

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Overview and Background

840-40-05-9

The Real Estate Subsections establish standards of financial accounting and reporting by a seller-lessee for sale-leaseback transactions involving real estate, including real estate with equipment, such as manufacturing facilities, power plants, and office buildings with furniture and fixtures.

Scope and Scope Exceptions

840-40-15-2

The guidance in this Subtopic may or may not apply to the following transactions:

- a. Paragraph 840-10-25-13 states that if the terms of the lease agreement require that the lessee indemnify the lessor or its lenders for preexisting environmental contamination, then the lessee shall assess at lease inception the likelihood of loss (before consideration of any recoveries from third parties) pursuant to that indemnification provision based on enacted environmental laws and existing regulations and policies in determining whether it should be considered the owner of the property. If the likelihood of loss is at least reasonably possible then the lessee shall be considered to have purchased, sold, and then leased back the property and the transaction would be subject to the sale-leaseback guidance in this Subtopic.
- b. [ASC 840-40-15-2(b) is included in Section 10.7.]

840-40-15-9

The guidance in the Real Estate Subsections applies to the following transactions:

- a. Sale-leaseback transactions that qualify for sales recognition under the guidance in paragraphs 360-20-40-57 through 40-59
- b. Sale-leaseback transactions involving real estate with equipment or equipment integral to real estate
- c. Sale-leaseback transactions involving only real estate
- d. Sale-leaseback transactions involving real estate with equipment in which the equipment and the real estate are sold and leased back as a package, irrespective of the relative value of the equipment and the real estate
- e. Sale-leaseback transactions in which the seller-lessee sells property improvements or integral equipment to a buyer-lessor and leases them back while retaining the underlying land
- f. Sale-leaseback transactions involving real estate with equipment that include separate sale and leaseback agreements that meet both of the following conditions:
 1. They are with the same entity or related parties.
 2. They are consummated at or near the same time, suggesting that they were negotiated as a package.

840-40-15-10

The guidance in the Real Estate Subsections does not apply to the following transactions:

- a. Sale-leaseback transactions that do not qualify for sales recognition under the guidance in paragraph 360-20-40-56.

ASC 840-40 includes accounting rules for sale-leaseback transactions involving real estate, including real estate with equipment, such as an office building, a manufacturing facility or a refinery. This guidance, which is included in real estate subsections of ASC 840-40, was codified primarily from Statement 98 and related standards. Statement 98 was issued in an effort to eliminate inconsistencies in the accounting results that were obtained under the application of sale-leaseback guidance for non-real estate transactions (i.e., guidance in Statement 13 that has also been codified primarily in ASC 840-40) and the application of real estate sales guidance (i.e., guidance in Statement 66 that has been codified primarily in ASC 360-20). As noted in ASC 840-40-15-2(a), if the terms of a lease agreement require that the lessee indemnify the lessor or its lenders for preexisting environmental contamination and the likelihood of loss (at lease inception – see Section 2.2) is at least reasonably possible (i.e., the chance of occurring is more than remote), then the lessee would be considered to have purchased, sold and then leased back the property, and the transaction, if real estate, would be subject to the applicable sale-leaseback provisions (see Section 2.9.1.4 for further discussion).

Excerpt from Accounting Standards Codification**Sale-Leaseback Accounting**

A method of accounting for a sale-leaseback transaction in which the seller-lessee records the sale, removes all property and related liabilities from its balance sheet, recognizes gain or loss from the sale, and classifies the leaseback in accordance with the Lessees Subsections of Subtopic 840-40.

Leases – Sale-Leaseback Transactions**Recognition****840-40-25-9**

Sale-leaseback accounting shall be used by a seller-lessee only if a sale-leaseback transaction meets all of the following criteria:

- a. It meets the definition of a normal leaseback.
- b. The payment terms and provisions adequately demonstrate the buyer-lessor's initial and continuing investment in the property as described in paragraphs 360-20-40-9 through 40-24.
- c. The payment terms and provisions transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee described in paragraphs 360-20-40-37 through 40-64, 840-40-25-13 through 25-14, and 840-40-25-17.

A sale-leaseback transaction that qualifies for sales recognition under the provision of the real estate subsections of ASC 840-40 is accounted for as a sale-leaseback regardless of whether the leaseback is classified as a capital lease or an operating lease under ASC 840-10-25. The provisions within the real estate subsections of ASC 840-40 apply to all sale-leaseback transactions involving real estate, even those that involve the leaseback of only a portion of the real estate sold.

The steps to account for sale-leaseback transactions involving real estate are the following:

1. Determine whether the “sale” of the real estate satisfies the criteria of ASC 360-20, *Property, Plant, and Equipment – Real Estate Sales*, and ASC 840-40-25-9.
2. If the real estate sale criteria are met, determine the gain that would be recognized under ASC 360-20 if the transaction did not involve a concurrent leaseback of the property.
3. Account for the gain in accordance with the provisions of ASC 840-40 for all sale-leaseback transactions (see Section 8.1), which generally require deferral and amortization of the gain and prohibit up-front gain recognition if substantially all of the property sold is leased back.

To the extent that the gain determined under the provisions of ASC 360-20 exceeds (a) the present value of the minimum lease payments (see Section 2.9) if the leaseback is classified as an operating lease or (b) the recorded amount of the leased asset if the leaseback is classified as a capital lease, that gain would be recognized currently, assuming the leaseback is more than minor but less than substantially all of the use of the asset (ASC 840-40-25-3 – see Section 8). The total gain is recognized immediately if the leaseback is considered minor (see Section 8.1.2).

Sale-leaseback accounting requires a seller-lessee to record a sale, remove the property from the balance sheet and recognize profit in accordance with the provisions of ASC 840-40-25-3 through 25-4 (described in Section 8.1). ASC 360-20 contains criteria for profit recognition for sales of real estate. It precludes sales recognition in certain circumstances and limits the amount of profit that can be recognized in other circumstances. A seller-lessee can use sale-leaseback accounting for a transaction involving real estate, or real estate with equipment, only if the transaction first qualifies as a sale under ASC 360-20. In this regard, if the seller-lessee has *any* continuing involvement with the property, other than a normal leaseback (see Sections 9.1 and 9.2), the seller would be precluded from accounting for the transaction as a sale. Instead, the transaction should be accounted for either as a financing transaction or by using the deposit method (ASC 840-40-25-11 – see Section 9.2).

As discussed in Section 8.1.12, lessees are required to apply sale-leaseback accounting guidance to modifications of capital lease arrangements that give rise to a new arrangement which is classified as an operating lease (ASC 840-40-15-6 – see Section 8.1.12). Consequently, when a capital lease for real estate and/or integral equipment is terminated or modified, and in conjunction with the termination or modification the lessee enters into an operating lease with the lessor, lessees should apply the provisions applicable to sale-leaseback transactions involving real estate in ASC 840-40 to determine whether the asset under capital lease and the related obligation should be derecognized, and the amount of gain or loss to be recognized (or deferred), if any.

Because of the extremely restrictive criteria of the accounting provisions in ASC 840-40 that pertain specifically to sale-leasebacks of real estate, the number of transactions involving real estate that qualify for sale-leaseback accounting is reduced significantly. For transactions involving real estate or real estate with equipment to qualify for sale-leaseback accounting, the transaction must satisfy each of the following criteria:

1. The leaseback must be deemed to be a “normal leaseback” (see Section 9.1).
2. The sale-leaseback agreement must include payment terms and provisions that adequately demonstrate the buyer-lessor’s initial and continuing investment in the property acquired (see our Real estate sales FRD for further discussion).
3. Payment terms and provisions must transfer all of the risks and rewards of ownership as demonstrated by the absence of any continuing involvement by the seller-lessee other than a normal leaseback (see Section 9.2).

See Section 8.1.11 for a discussion of the impact of a transfer of a purchase option and the related applicability of sale-leaseback accounting.

9.1 Normal leaseback requirement

Excerpt from Accounting Standards Codification

Normal Leaseback

A lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee, and excludes other continuing involvement provisions or conditions described in paragraphs 840-40-25-14.

Active Use of the Property

The use of the property by the seller-lessee during the lease term in the seller-lessee's trade or business, provided that subleasing of the leased-back property is minor.

Active use of the property may involve the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, the following:

- a. Housekeeping
- b. Inventory control
- c. Entertainment
- d. Bookkeeping
- e. Food services.

Leases – Sale-Leaseback Transactions

Overview and Background

840-40-05-10

The Real Estate Subsections distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. The latter type of contingent rental is addressed in paragraph 840-40-25-14(e).

Recognition

840-40-25-10

Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges shall be considered in evaluating the continuing involvement provisions in paragraphs 840-40-25-13 through 25-14 and 840-40-25-17. Those terms or conditions include, but are not limited to, the sales price, the interest rate, and other terms of any loan from the seller-lessee to the buyer-lessor. The fair value of the property used in making that evaluation shall be based on objective evidence, for example, an independent third-party appraisal or recent sales of comparable property.

Implementation Guidance and Illustrations**840-40-55-35**

Active use of the property refers to the use of the property by the seller-lessee in its trade or business. The definition restricts subleasing of the property to a minor amount.

840-40-55-36

Although the use of property by a seller-lessee engaged in the hotel or bonded warehouse business or the operation of a golf course or a parking lot, for example, appears to be no different from subleasing office space because the seller-lessee is allowing others to use the property, the use of property in those circumstances is considered active use.

A “normal leaseback” is defined as a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for rental payments, including contingent rents that are based on future operations of the seller-lessee. The property leased back must be used during the lease term in the seller-lessee’s trade or business, and any subleasing of the leased back property must be “minor,” regardless of whether the seller-lessee’s business is leasing real estate. Otherwise the sale and lease do not qualify as a sale-leaseback. Subleasing is considered minor if the present value of the sublease rental payments is not more than 10% of the fair value of the property sold. If the present value of the sublease rental payments exceeds 10%, the transaction is to be accounted for as a financing or by using the deposit method (as specified in ASC 360-20).

In determining the amount of subleasing, the sublease rental payments should be calculated based on existing leases in place at the time of the sale-leaseback (including any renewal periods) plus a reasonable amount of rent for all space the seller-lessee does not intend to occupy.

9.1.1 **Seller leases back less than 100% of property sold**

The real estate sale-leaseback provisions of ASC 840-40 apply regardless of whether the seller-lessee leases back 100% or 1% of the property sold. For example, if the property sold is a twenty-floor office building and ten floors are leased back, sale-leaseback accounting for real estate sale-leaseback transactions under the provisions of ASC 840-40 is applicable. If the leaseback is considered minor, that is, if the present value of the rental payments is less than 10% of the total property’s fair value and no prohibited forms of continuing involvement exist (see Section 9.2), the sale and leaseback would be treated as separate transactions and any gain (determined in accordance with the provisions of ASC 360-20) would be recognized currently, assuming that the provisions of ASC 360-20 are met. If a prohibited form of continuing involvement exists, the seller must treat the transaction under the deposit method or as a financing even if the leaseback is minor.

9.2 **Continuing involvement**

In a real estate sale-leaseback transaction, if the seller-lessee has any continuing involvement with the property, other than a normal leaseback, the seller would be precluded from accounting for the transaction as a sale. Instead, the transaction should be accounted for either as a financing transaction or by using the deposit method.

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Recognition

840-40-25-11

A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback shall be accounted for by the deposit method or as a financing, whichever is appropriate under Subtopic 360-20.

840-40-25-12

The provisions or conditions described in paragraphs 840-40-25-13 through 25-14 and 840-40-25-17 are examples of continuing involvement for the purpose of applying the guidance in this Subtopic.

840-40-25-13

Paragraphs 360-20-40-37 through 40-64 describe forms of continuing involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Two examples of continuing involvement specified in those paragraphs that are frequently found in sale-leaseback transactions are provisions or conditions in which:

- a. The seller-lessee has an obligation or an option to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property. A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase. A default remedy that allows the buyer-lessor to put the leased property to the seller-lessee would violate the continuing involvement criteria in this Subtopic and, therefore, the transaction would be accounted for by the deposit method or as a financing, as appropriate. An option on the part of the buyer-lessor to put the leased property to the seller-lessee in the event of a default by the seller-lessee is tantamount to a purchase option by the seller-lessee because it would be within the control of the seller-lessee to economically compel the buyer-lessor to put the leased property to the seller-lessee (for example, if the seller-lessee ceased making its scheduled lease payments).
- b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time.

840-40-25-14

Other provisions or conditions that are guarantees and that do not transfer all of the risks of ownership shall constitute continuing involvement for the purpose of applying this Subtopic to sale-leaseback transactions and include, but are not limited to, the following:

- a. The seller-lessee is required to pay the buyer-lessor at the end of the lease term for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.
- b. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.
- c. The seller-lessee is not relieved of the obligation under any existing debt related to the property.
- d. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment. Except as noted in paragraph 840-40-25-16, an uncollateralized,

irrevocable letter of credit is not a form of continuing involvement that precludes sale-leaseback accounting under this Subtopic. The continuing involvement guidance in this Subtopic does not preclude a lessee from providing an independent third-party guarantee of the lease payments in a sale-leaseback transaction. However, all written contracts that exist between the seller-lessee in a sale-leaseback transaction and the issuer of a letter of credit must be considered. For example, a financial institution's right of setoff of any amounts on deposit with that institution against any payments made under the letter of credit constitutes collateral and, therefore, is a form of continuing involvement that precludes sale-leaseback accounting under this Subtopic.

- e. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessor.

840-40-25-15

An entity's unsecured guarantee of its own lease payments is not a form of continuing involvement that precludes sale-leaseback accounting under this Subtopic because such a guarantee does not provide the buyer-lessor with additional collateral that reduces the buyer-lessor's risk of loss, except in the event of the seller-lessee's bankruptcy.

840-40-25-16

An unsecured guarantee of the lease payments of one member of a consolidated group by another member of the consolidated group is not a form of continuing involvement that precludes sale-leaseback accounting under this Subtopic in the consolidated financial statements. However, an unsecured guarantee of the lease payments of one member of a consolidated group by another member of the consolidated group is a form of continuing involvement that precludes sale-leaseback accounting under this Subtopic in the separate financial statements of the seller-lessee because such a guarantee provides the buyer-lessor with additional collateral that reduces the buyer-lessor's risk of loss.

840-40-25-17

The following provisions or conditions also shall be considered examples of continuing involvement for the purpose of applying this Subtopic to sale-leaseback transactions:

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

840-40-25-18

A partial sale transaction precludes the use of sale-leaseback accounting due to the continuing involvement of the seller-lessee. The continuing involvement conditions in this Subtopic are intended to be interpreted restrictively as indicated by the broad prohibitions of paragraphs 840-40-25-12 through 25-17.

To the extent continuing involvement arises after entering into the sale-leaseback, such continuing involvement should be evaluated on a facts and circumstances basis to determine if it was contemplated when the sale-leaseback was entered into.

Examples of continuing involvement, regardless of whether they are only present in the event of a contingency, that prohibit sales recognition and instead require accounting under the deposit or financing method include:

- ▶ The existence of an option to repurchase the property sold, even though the option price is equal to the then fair value of the property at the date the option is exercised. A “right of first refusal” does not constitute an option to repurchase. See Section 9.2.2, for a further discussion of a right of first refusal.
- ▶ An obligation on the part of the seller-lessee to repurchase the property sold, or the ability of the buyer-lessor to compel the seller-lessee to repurchase the property at any time in the future.
- ▶ The seller-lessee or a party related to the seller-lessee guarantees the buyer-lessor’s investment or a return on that investment for either a limited or extended period of time. For example, a guarantee by the parent company of a lease entered into by a subsidiary of the parent constitutes a form of continuing involvement. Payments required by the seller-lessee for a decline in the fair value of the property, including a guaranteed residual value, also constitute a form of continuing involvement by the seller-lessee.
- ▶ Any form of continuing ownership in the property. For example, if the seller-lessee sold the property to a partnership in which the seller has a partnership interest, no matter how minor, sales recognition would be prohibited.
- ▶ The seller-lessee provides non-recourse financing to the buyer-lessor for any portion of the sales price or provides recourse financing in which the only recourse available to the seller is the property sold. This provision also applies to financial institutions that in the normal course of business provide real estate financing. In addition, if recourse financing is provided but the buyer-lessor is a non-substantive lessor, such recourse financing would be viewed as continuing involvement.
- ▶ The seller-lessee is not relieved of its obligation under any existing debt related to the property. For example, if the seller-lessee remains secondarily liable on outstanding indebtedness related to the property sold, sales accounting is prohibited.
- ▶ The seller-lessee provides collateral to lenders or the buyer-lessor other than the property directly involved in the sale-leaseback transaction, or the seller-lessee (or a related party to the seller-lessee) guarantees the buyer-lessor’s debt.
- ▶ The seller-lessee’s rental payments are contingent on some predetermined or determinable level of future operations of the buyer-lessor.
- ▶ The seller-lessee enters into a sale-leaseback transaction of real estate that also involves property improvements or equipment without selling or leasing the underlying land to the buyer-lessor.
- ▶ The seller-lessee is required to initiate or support operations or continues to operate the property at its own risk, for an extended period, for a specified limited period, or until a specified level of operations has been achieved (for example, until rentals of a property are sufficient to cover operating expenses and debt service).
- ▶ Any provision or circumstance that allows the seller-lessee to participate in any future profits of the buyer-lessor or the appreciation of the leased property; for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessor. This would include any provision that requires the buyer-lessor to share any appreciation in the property with the seller-lessee, either directly or as compensation for other services (e.g., lessee receiving sales commission on the sale of the property or a variable management fee on ongoing operations).

Note that this is not a comprehensive list of items that constitute continuing involvement. ASC 840-40-25-10 (see Section 9.1) notes that to the extent the terms of a sale-leaseback transaction are substantially different from terms that an independent third-party lessor or lessee would accept, they represent an exchange of some stated or unstated rights or privileges. Those rights and privileges should be considered in evaluating the continuing involvement provisions of ASC 840-40 related to real estate sale-leaseback transactions. The terms and conditions include, but are not limited to, the sales price, the interest rate and other terms of any loan from the seller-lessee to the buyer-lessor (see also Section 9.2.12).

Please see the sections that follow for additional guidance on continuing involvement (including Section 9.7 for discussion of rental shortfall agreements).

9.2.1 Lease renewals

Certain lease transactions provide the lessee with the right to continue to extend the lease, at a fixed price rental (not a bargain renewal – see Section 2.5), for substantially all (i.e., 90% or more) of the asset's remaining economic life. In a sale-leaseback transaction, the ability of the lessee to extend the lease for at least 90% of the asset's remaining useful life is tantamount to a form of continuing involvement prohibited under the provisions for real estate sale-leaseback transactions in ASC 840-40. If, however, the renewal options were at fair value, as determined on renewal, we believe they would be permissible under the provisions for real estate sale-leaseback transactions, as a determination to renew would be based on market conditions and at market terms at the time of the renewal.

9.2.2 Right of first refusal

A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase. As a result, care must be taken that the right of first refusal is predicated on a "real" offer from an unrelated third party, with the ability and intention to purchase the asset.

In a related issue, certain sale-leaseback transactions provide that the seller-lessee has the right to make a first offer to buy the property at the end of the lease term. As long as the buyer-lessor is not compelled to accept this offer and the offer amount can be determined by the lessee (as opposed to a formula basis) and it is not accompanied by any other obligations on the part of the lessee or lessor, a right of first offer is not a prohibited form of continuing involvement. If the lessee is compelled to make the offer (e.g., under the contract in an event of default), the right of first offer is effectively a lessor put, resulting in a failed sale-leaseback. If the lessor is compelled to accept the offer, it is effectively a purchase option, resulting in a failed sale-leaseback (ASC 840-40-25-13(a) – see Section 9.2).

9.2.3 Purchase option outside base lease term

In certain lease agreements, a purchase option exists in a renewal period that is outside the base lease term. Any purchase option is a prohibited form of continuing involvement regardless of the lease term it is included in or whether it is contingent on some future event.

9.2.4 Continuing involvement based on a contingency

We have viewed continuing involvement based on or triggered by a contingency (including default) as continuing involvement (the probability of the contingency occurring is not considered). The following are common types, although not all inclusive, of contingent continuing involvement and our views thereon:

Default provisions

We have occasionally seen sale-leaseback agreements which, upon default of either the lessee or lessor, trigger some form of continuing involvement. As noted previously, a contingent form of continuing involvement is still continuing involvement that results in a failed sale-leaseback. One example is that, as

a remedy or consequence of a default, the lessee is required to offer to purchase the property from the lessor or the lessor has an obligation or option to offer the property for sale to the lessee. Because the provisions of ASC 840-40 applicable to real estate sale-leaseback transactions are designed to preclude sale-leaseback accounting when any provision exists that would enable (or compel) the lessee to acquire the property (whether automatic or under an option at either a stated value or fair value), the presence of any such default provision would prohibit sale-leaseback accounting. Once again the likelihood of default occurring is not considered.

Indemnities for casualty and condemnation

In most instances, we have not viewed the lessee assuming risk of loss for property risk, including risks related to casualty and condemnation, as a prohibited form of continuing involvement as long as the property risk is insurable and insured (or self insured if that is how the seller-lessee has managed such risk in the past) or the risk of loss is remote if not insurable.

Tax indemnities

A lease agreement whereby a seller-lessee participates in favorable tax treatment provided to the owner-lessor constitutes a prohibited form of continuing involvement. The same would be true for a tax indemnity provided by the seller-lessee to the buyer-lessor as to the tax treatment of the assets purchased or for changes in tax law. If, however, the indemnity relates directly to misrepresentation of the seller-lessee, the indemnity would not be a prohibited form of continuing involvement.

9.2.5

Default remedies

A default remedy that allows the buyer-lessor to put the leased property to the seller-lessee would violate the continuing involvement criteria and, therefore, the real estate sale-leaseback transaction would be accounted for by the deposit method or as a financing, whichever is appropriate under ASC 360-20. An option on the part of the buyer-lessor to put the leased property to the seller-lessee in the event of a default by the seller-lessee is tantamount to a purchase option by the seller-lessee because it would be within the control of the seller-lessee to economically compel the buyer-lessor to put the leased property to the seller-lessee (for example, if the seller-lessee ceased making its scheduled lease payments) (ASC 840-40-25-13(a) – see Section 9.2).

A default remedy that results in the acceleration of minimum lease payments would not, however, constitute continuing involvement so long as title to the leased asset does not revert to the seller-lessee and the lease is terminated.

9.2.6

Unsecured guarantee by parent of subsidiary's lease payments in a sale-leaseback transaction

An entity's unsecured guarantee of its own lease payments is not a form of continuing involvement that precludes sale-leaseback accounting for real estate sale-leaseback transactions because such a guarantee does not provide the buyer-lessor with additional collateral that reduces the buyer-lessor's risk of loss, except in the event of the seller-lessee's bankruptcy (ASC 840-40-25-15 – see Section 9.2). An unsecured guarantee of the lease payments of one member of a consolidated group by another member of the consolidated group is not a form of continuing involvement that precludes sale-leaseback accounting in the consolidated financial statements. However, an unsecured guarantee of the lease payments of one member of a consolidated group by another member of the consolidated group is a form of continuing involvement that precludes sale-leaseback accounting for a transaction involving real estate in the separate financial statements of the seller-lessee because such a guarantee provides the buyer-lessor with additional collateral that reduces the buyer-lessor's risk of loss (ASC 840-40-25-16 – see Section 9.2).

9.2.7 Impact of an uncollateralized irrevocable letter of credit on a real estate sale-leaseback transaction

An uncollateralized, irrevocable letter of credit is not a form of continuing involvement that precludes sale-leaseback accounting for transactions involving real estate. The continuing involvement provisions for real estate sale-leaseback transactions do not preclude a lessee from providing an independent third-party guarantee of the lease payments in a sale-leaseback transaction. However, all written contracts that exist between the seller-lessee in a sale-leaseback transaction and the issuer of a letter of credit must be considered. For example, a financial institution's right of setoff of any amounts on deposit with that institution against any payments made under the letter of credit constitutes collateral and, therefore, is a form of continuing involvement that precludes sale-leaseback accounting for transactions involving real estate (ASC 840-40-25-14(d) – see Section 9.2).

9.2.8 Partial sale-leaseback

Partial sale transactions preclude the use of sale-leaseback accounting due to the continuing involvement of the seller-lessee. For example, a utility that owns a 30% undivided interest in an electric generating facility enters into a sale-leaseback of a 7% undivided interest, which would leave the utility a 23% ownership interest and a 7% leasehold interest. The continuing ownership of the 23% interest would prohibit the use of sale-leaseback accounting (ASC 840-40-25-18 – see Section 9.2). Noteworthy is that the prohibition on partial sale-leasebacks applies no matter the size of the retained interest.

9.2.9 Sale of a real property without a sale of the underlying land

The sale of property improvements without a sale or lease of the underlying land would constitute a prohibited form of continuing involvement. If the underlying land is leased, the lease must be for the entire useful life of the property improvements (ASC 840-40-25-17(a) – see Section 9.2).

9.2.10 Lessee participation in lessor's interest savings

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-48

A provision in a sale-leaseback agreement that allows the seller-lessee to require the buyer-lessor to refinance debt related to the property and pass through the interest savings to the seller-lessee would preclude sale-leaseback accounting for the transaction. However, changes in leaseback payments that are indexed to an interest rate are contingent rental payments and would not preclude sale-leaseback accounting, even though the economic effect of the two provisions might be very similar.

9.2.11 Impact of condominiumization on sale-leaseback accounting

A legal condominiumization of real estate enables real estate to be divided and sold in multiple pieces. Condominiumization could involve separate floors within a building as well as separate structures located on a campus. Evaluating whether a sale-leaseback of a condominium interest falls within the continuing involvement criteria prohibiting a partial sale-leaseback of real estate (see Section 9.2.8) requires a careful analysis of the facts and circumstances. Factors to evaluate include:

- ▶ Proximity of dividing real estate interests (condominiumization) and sale-leaseback transaction
- ▶ Physical relationship of property (part of a building, adjoining buildings, etc.)
- ▶ The economic substance of the transaction

To the extent the dividing of a building into separate legal interests is performed as part of a sale-leaseback transaction and it is solely because of the separate legal interests that the sale-leaseback transaction does not contain a prohibited form of continuing involvement (or is a normal leaseback), the transactions would be viewed as one sale-leaseback transaction similar to a partial sale-leaseback. If, however, the division of the building had been accomplished several years prior to the sale-leaseback transaction and the seller-lessee had a history of selling condominium interests in the building, or other significant business purpose, the transaction could be evaluated on a separate legal interest basis.

9.2.12 Sales price significantly less than fair value

A sale-leaseback transaction in which the sales price is significantly less than fair value needs to be evaluated carefully to determine if, in substance, it is a prohibited form of continuing involvement. By selling an asset at a significant discount from its market value, the seller-lessee may indirectly be providing financing to the buyer-lessor.

ASC 840-40-25-10 (see Section 9.1) notes that the fair value of the property used in making the evaluation of whether the terms of a sale-leaseback are substantially different from the terms that an independent third-party lessor or lessee would accept (and may represent financing to the buyer-lessor) should be based on objective evidence. Examples of objective evidence include an independent third-party appraisal or recent sales of comparable property, and we believe that it should not be affected by the favorability or unfavorability of the lease being evaluated (including the leaseback of an asset accounted for as a sale-leaseback of real estate under ASC 840-40). That is, fair value should not be increased or decreased based on the cash flows associated with the rental agreement, but instead should be based on market factors. Please see Section 2.3.1 for additional guidance on determining fair value.

9.2.13 Lease payments

In the event that lease payments are structured so that a significant amount of payments are made in the early portion of the leaseback term, the lease payments may, in substance, be a prohibited form of continuing involvement. By making significant payments in the early portion of a leaseback, the seller-lessee might indirectly be providing financing or collateral to the buyer-lessor. We view early lease payments that significantly vary from straight-line rent payments as a form of prohibited continuing involvement.

9.3 Accounting for transactions with continuing involvement

If there is a prohibited form of continuing involvement (in a sale-leaseback transaction involving real estate) by the seller-lessee, ASC 840-40-25-11 (see Section 9.2) requires that the transaction be accounted for either as a financing or by using the deposit method. The selection of the appropriate method is governed by the provisions of ASC 360-20; however, in many cases, the financing method will be used. A discussion of each of the methods follows.

9.3.1 Financing method

Under the financing method, the asset subject to the sale-leaseback remains on the balance sheet of the seller-lessee and continues to be depreciated. Sale proceeds (consideration) are recorded as a liability. Lease payments less the portion considered to be interest expense decrease the financing liability, and collections on any buyer-lessor's note increase the financing liability (ASC 840-40-55-63).

If a sale-leaseback transaction that is accounted for as a financing subsequently qualifies for sales recognition under ASC 840-40 and ASC 360-20, the transaction would, at that time, be accounted for using sale-leaseback accounting, and the cumulative change in the related balance sheet accounts would be included in the computation of the gain. In addition, the leaseback would be classified and accounted for in accordance with ASC 840-10-25-1 (see Section 3.2) (as a capital or operating lease) as if the sale-

leaseback transaction had been recognized at the inception of the lease. If the leaseback meets one of the criteria for classification as a capital lease, the related asset accounts, including accumulated amortization, are established as of the date the sale is recognized to reflect accumulated amortization and interest that would have been charged to expense had the capitalized lease been recorded at its inception. The change in the related lease accounts from the inception of the lease to the date the sale is recognized for financial reporting purposes is included in the gain recognized or deferred under ASC 840-40-55-49 – see Section 9.4.1 – (ASC 840-40-55-71).

The following examples illustrate the application of the financing method to a sale-leaseback transaction:

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-63

This Subtopic and paragraphs 360-20-40-37 through 40-64 describe some common forms of continuing involvement with the property by the seller that preclude a sale-leaseback transaction from sale-leaseback accounting. Depending on the nature and duration of the continuing involvement with the property, that guidance may require a sale-leaseback transaction to be accounted for as a financing. As illustrated in this Example, if a sale-leaseback transaction is reported as a financing, lease payments, exclusive of an interest portion, decrease and collections on the buyer-lessor's note increase the seller-lessee's liability account with a portion of the lease payments being recognized under the interest method. The seller-lessee reports the sales proceeds as a liability, continues to report the real estate or the real estate and equipment as an asset, and continues to depreciate the property.

840-40-55-64

Entity C (a seller-lessee) sells one of its older special-purpose buildings at its principal manufacturing facility to a buyer-lessor for \$950,000 (the fair value of the property as determined by an independent third-party appraisal) and enters into an agreement to lease the building back for 5 years at \$100,000 per year. In addition, the agreement includes an option that allows the seller-lessee to renew the lease for an additional 5 years at \$100,000 per year (estimated to be the then fair-market rental). The lease agreement also includes a fair value repurchase option during the initial lease term, and the seller-lessee guarantees that the residual value of the property will be no less than \$920,000 at the end of the initial lease period. The special-purpose building has a historical cost of \$3,510,000 and accumulated depreciation at the date of the transaction of \$2,660,000. Depreciation expense is \$70,000 per year. In exchange for the building, the seller-lessee receives \$50,000 and a 10-year \$900,000 recourse note with a 10 percent annual interest rate.

840-40-55-65

The seller-lessee accounts for this transaction as a financing because of the continuing involvement associated with the guarantee and the repurchase option. At the end of Year 5, the seller-lessee exercises the renewal option, and the continuing involvement with the property is no longer at issue because the repurchase option and the guarantee no longer exist. The seller-lessee recognizes the transaction as a sale and classifies the leaseback as an operating lease because none of the criteria in paragraph 840-10-25-1 is met.

[Illustrations in paragraphs 840-40-55-66 through 840-40-55-70, which illustrate the calculation of the gain, the allocation of the gain, and the related journal entries, were not reproduced. Refer to example below for examples of these calculations.]

840-40-55-71

This Example illustrates that, if a sale-leaseback transaction accounted for as a financing subsequently qualifies for sales recognition under this Subtopic and Subtopic 360-20, the transaction is then recorded using sale-leaseback accounting, and the cumulative change in the related balance sheet accounts is included in the computation of the gain recognized in accordance with the guidance in paragraph 840-40-55-49. In addition, the leaseback is classified and accounted for in accordance with paragraph 840-10-25-1 as if the sale had been recognized at lease inception. If the leaseback meets one of the criteria for classification as a capital lease, the related lease accounts, including accumulated amortization, are established as of the date the sale is recognized to reflect accumulated amortization and interest that would have been charged to expense had the lease been recorded at its inception. The change in the related lease accounts from lease inception to the date the sale is recognized is included in the gain recognized in accordance with paragraph 840-40-55-49.

840-40-55-72

Entity D (a seller-lessee) sells the building at one of its manufacturing facilities to a buyer-lessor for \$950,000 (the fair value of the property as determined by an independent third-party appraisal) and enters into an agreement to lease the building back for 5 years at \$100,000 per year. In addition, the seller-lessee has an option to renew the lease for an additional 5 years at \$110,000 (estimated to be the then fair-market rental). The lease agreement also includes a fair value repurchase option, and the seller-lessee guarantees that the residual value of the property will be no less than \$950,000 at the end of the initial lease period. The property has a historical cost of \$1,200,000 and accumulated depreciation at the date of the transaction of \$400,000. Depreciation expense is \$80,000 per year.

840-40-55-73

Because of the continuing involvement associated with the guarantee and the repurchase option, the seller-lessee accounts for this transaction as a financing in accordance with the guidance in this Subtopic. At lease inception, it is known that the seller-lessee is developing a new manufacturing process that will require a different manufacturing facility. The new technology becomes available at the end of the initial lease term, and the seller-lessee vacates the property. The fair value of the property (as determined by an independent third-party appraisal) at that time is \$915,000. The seller-lessee honors the \$950,000 guarantee of the property by paying the buyer-lessor \$35,000 and recognizes the sale of the property.

840-40-55-74

The gain on the transaction is recognized as follows.

Calculation of the Gain before the Effect of the Guarantee

Sales price (at inception)	\$ 950,000
Cost less accumulated depreciation (end of year 5)	<u>400,000</u>
Total gain to be recognized	<u>\$ 550,000</u>

840-40-55-75

Entity D would make the following journal entries.

At inception:

Cash	\$ 950,000	
Finance obligation		\$ 950,000

To record the receipt of the proceeds from the sale of the property

Recurring journal entries in Years 1-5:

Depreciation expense	\$ 80,000	
Accumulated depreciation		\$ 80,000

To record the depreciation expense

Interest expense	\$ 100,000	
Cash		\$ 100,000

To record the lease payments (Interest expense is calculated under the interest method using an effective yield of 10.5263 percent and the guaranteed residual as the last payment.)

When the sale is recognized:

Accumulated depreciation	\$ 800,000	
Finance lease obligation	950,000	
Property, plant, and equipment		\$ 1,200,000
Cash		35,000
Gain on sale of property		515,000

To record the transaction as a sale

840-40-55-76

Under the guidance in this Subtopic, gain deferral is not required because the seller-lessee no longer occupies or otherwise benefits from the property and no longer has any guarantee or other continuing involvement.

840-40-55-77

The annual balances in the related balance sheet accounts are as follows.

(1) Period	(2) Finance Obligation	(3) Property, Plant, and Equipment	(4) Accumulated Depreciation
At inception	\$ 950,000	\$ 1,200,000	\$ 400,000
Year 1	950,000	1,200,000	480,000
Year 2	950,000	1,200,000	560,000
Year 3	950,000	1,200,000	640,000
Year 4	950,000	1,200,000	720,000
Year 5	950,000	1,200,000	800,000
When property is vacated	–	–	–

9.3.1.1**Appropriate interest rate to use**

Neither ASC 840-40 nor ASC 360-20 discuss the appropriate interest rate to use in a failed sale-leaseback that is accounted for as a financing. While generally we believe the appropriate interest rate to use is the lessee's incremental borrowing rate (see Section 2.11), to the extent that rate would result in either negative amortization or a built-in loss at the end of the lease (e.g., net book value in excess of the financing obligation), the rate should be adjusted to eliminate such results.

9.3.2 Deposit method

In certain real estate sales situations ASC 360-20 specifically requires the use of the deposit method of accounting. For example, use of the deposit method is required if all conditions precedent to closing have not been performed (ASC 360-20-40-28). Under the deposit method, any down payment and payments of principal and interest received are recorded as a deposit liability. Lease payments decrease and collections on any buyer-lessor's note increase the deposit liability account. The property would continue to be recognized in the seller-lessee's balance sheet and the seller-lessee would continue to depreciate the property (ASC 840-40-55-54).

If at any time the net carrying amount of the property exceeds the sum of the deposit received, the fair value of the unrecorded note receivable and the debt assumed by the buyer, the seller-lessee is required to recognize a loss for the excess (ASC 840-40-55-54). Also, if the buyer defaults or subsequent circumstances indicate that it is probable the buyer will default and the property will revert to the seller, the seller must evaluate whether the circumstances indicate that a decline in the value of the property has occurred for which a loss must be recognized.

If a sale-leaseback transaction accounted for by the deposit method subsequently qualifies for sales recognition under ASC 840-40 and ASC 360-20, the transaction, at that time, would be accounted for using sale-leaseback accounting, and the gain or loss recognized in accordance with the provisions of ASC 840-40. The subsequent recognition of a sale requires similar adjustments to those that would have been required had the financing method been used; however, the amounts will be different because interest expense is not recognized under the deposit method. In addition, the leaseback would be classified (in accordance with ASC 840-10-25) and accounted as if the sale had been recognized at the inception of the lease. If the leaseback meets one of the criteria for classification as a capital lease, the asset and liability accounts related to the leaseback, including accumulated amortization, would be recorded as of the date that the sale is recognized to reflect amortization that otherwise would have been charged to expense had the lease been recorded as a capital lease at its inception. The change in the related lease accounts that would have been recorded from the inception of the lease had the transaction initially qualified for sale-leaseback accounting is included in computing the gain or loss recognized (ASC 840-40-55-55).

The following example illustrates a sale-leaseback transaction accounted for by the deposit method with subsequent sales recognition and the leaseback classified as a capital lease:

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-54

Paragraphs 360-20-40-28 through 40-31, 360-20-40-41, and 360-20-40-45 describe certain circumstances in which it is appropriate to account for a transaction using the deposit method (as described in paragraphs 360-20-55-17 through 55-20). This Example illustrates that, if a sale-leaseback transaction is accounted for by the deposit method, lease payments decrease and collections on the buyer-lessor's note, if any, increase the seller-lessee's deposit account. The property and any related debt continue to be included in the seller-lessee's balance sheet, and the seller-lessee continues to depreciate the property. Under the guidance in paragraphs 360-20-40-29 through 40-30, a seller-lessee that is accounting for any transaction by the deposit method according to the guidance in this Subtopic should recognize a loss if at any time the net carrying amount of the property exceeds the sum of the balance in the deposit account, the fair value of the unrecorded note receivable, and any debt assumed by the buyer.

840-40-55-55

If a sale-leaseback transaction accounted for by the deposit method subsequently qualifies for sales recognition under this Subtopic and Subtopic 360-20, the transaction is accounted for using sale-leaseback accounting, and the gain or loss is recognized in accordance with the guidance in paragraph 840-40-55-49. In addition, the leaseback is classified and accounted for as if the sale had been recognized at lease inception. If the leaseback meets one of the criteria for classification as a capital lease, the asset and liability accounts related to the leaseback, including accumulated amortization, are recorded as of the date that the sale is recognized to reflect amortization that would have been charged to expense had the lease been recorded as a capital lease at its inception. The change in the related lease accounts that would have been recorded from lease inception had the transaction initially qualified for sale-leaseback accounting is included in computing the gain or loss recognized in accordance with paragraph 840-40-55-49.

840-40-55-56

Entity B (a seller-lessee) sells the building at one of its manufacturing facilities to a buyer-lessor for \$950,000 (the fair value of the property as determined by an independent third-party appraisal) and enters into an agreement to lease the building back for 10 years at \$150,000 per year. The property has a historical cost of \$1,300,000 and accumulated depreciation at the date of the transaction of \$400,000. Depreciation expense is \$80,000 per year. In exchange for the building, the seller-lessee receives \$50,000 and a 10-year \$900,000 recourse note with a 10 percent annual interest rate with annual payments of \$146,471.

840-40-55-57

The sale-leaseback transaction does not include any continuing involvement provisions, but the buyer-lessor has a questionable credit rating. Based on the poor credit standing of the buyer-lessor and the inadequate initial investment, the seller-lessee elects to account for the transaction by the deposit method. The initial and continuing investment must equal 20 percent of the sales price before it is appropriate to recognize profit by the full accrual method. Based on the amortization schedule of the buyer-lessor's note and assuming an improved credit rating of the buyer-lessor, income recognition under the full accrual method will be appropriate for the transaction at the end of Year 3. The leaseback meets the criteria for classification as a capital lease in accordance with the guidance in paragraph 840-10-25-1(c) through (d).

840-40-55-58

The calculation of the gain on the transaction is as follows.

Sales price (at inception)	\$ 950,000
Cost less accumulated depreciation (end of Year 3)	<u>660,000</u>
	290,000

Adjustments required by the deposit method or provisions of this Subtopic:

Amortization of capital asset not recognized	(285,000)
Interest income credited to the deposit account in Years 1-3 (credited to the deposit account as part of note payments received)	252,495
Interest expense charged to the deposit account in Years 1-3 (charged to the deposit account as part of lease payments)	<u>(247,363)</u>
Total gain to be recognized	<u>\$ 10,132</u>

840-40-55-59

Under the guidance in Subtopic 360-20 and absent the leaseback, a gain of \$10,132 would be recognized at the end of Year 3 under the full accrual method.

840-40-55-60

The allocation of the gain is as follows.

<u>Period recognized</u>	<u>Year 3 gain</u>
Year 4	\$ 1,447
Year 5	1,447
Year 6	1,447
Year 7	1,447
Year 8	1,448
Year 9	1,448
Year 10	<u>1,448</u>
Total	<u>\$ 10,132</u>

840-40-55-61

Entity B would make the following journal entries.

At inception:

Cash	\$ 50,000	
Deposit		\$ 50,000
<i>To record the receipt of the down payment on the property</i>		

Recurring journal entries in Years 1-3:

Cash	146,471	
Deposit		146,471
<i>To record the receipt of collections on the buyer-lessor's note (the annual payment required for a 10 year \$900,000 note)</i>		
Deposit	150,000	
Cash		150,000
<i>To record the lease payments</i>		
Depreciation expense	80,000	
Accumulated depreciation		80,000
<i>To record the depreciation expense</i>		

When the sale is recognized at end of Year 3:

Deposit	\$ 39,413	
Capital asset	950,000	
Note receivable	713,082	
Accumulated depreciation	640,000	
Property, plant, and equipment		\$ 1,300,000
Capital lease obligation		747,363
Accumulated amortization of the capital asset		285,000
Deferred gain		10,132
<i>To recognize the sale and to record the capitalization of the leased asset</i>		

9.4 Accounting for transactions without continuing involvement

A sale-leaseback transaction that qualifies for sales recognition under the provisions for real estate sale-leaseback transactions in ASC 840-40 is accounted for using sale-leaseback accounting by the seller-lessee whether the leaseback is classified as a capital lease or an operating lease. The approach is first to determine the gain that would be recognized for the sale of real estate under ASC 360-20 as if the transaction were a sale without a leaseback and then to allocate that gain as provided by ASC 840-40 over the remaining lease term in proportion to the amortization of the leased asset if the leaseback is a capital lease. The gain to be deferred and amortized in proportion to the leaseback is the gain that would otherwise be recognized in that year under the provisions of ASC 360-20, except for the amount that can be recognized currently under ASC 840-40-25-3 (see Section 8). The total gain is recognized immediately if the leaseback is considered minor (see Section 8.1). If the leaseback is other than minor but less than substantially all, the gain to be recognized currently is the amount of gain in excess of (a) the present value of the minimum lease payments if the leaseback is classified as an operating lease or (b) the recorded amount of the leased asset if the leaseback is classified as a capital lease.

The following examples illustrate profit recognition in real estate sale-leaseback transactions without continuing involvement that satisfy the criteria for sales of real estate under ASC 360-20:

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

Example 5: Leaseback of Real Estate that Is Minor

840-40-55-78

This Example illustrates application of the guidance in paragraph 840-40-25-3.

840-40-55-79

An entity constructs a regional shopping center and sells it to a real estate management firm. The sale meets the criteria in paragraph 360-20-40-5 for full and immediate profit recognition. At the same time, the seller leases back for 40 years a part of the facility, estimated to be approximately 8 percent of the total rental value of the center. This Example has the following assumptions.

Sales price	\$ 11,200,000
Cost of shopping center	\$ 10,000,000

840-40-55-80

The rental called for by the lease appears to be reasonable in view of current market conditions. The seller-lessee would record the sale and recognize \$1,200,000 profit. The seller-lessee would account for the leaseback as though it were unrelated to the sale because the leaseback is a minor leaseback.

Example 7: Leaseback that Is Not Minor but Does Not Cover Substantially All of the Use of the Property

840-40-55-85

This Example illustrates application of the guidance in paragraph 840-40-25-2.

840-40-55-86

An entity sells an existing shopping center to a real estate management firm. The sale meets the criteria of paragraph 360-20-40-5 for full and immediate profit recognition. At the same time, the seller leases back the anchor store with corresponding use of the related land. The leased space is estimated to comprise approximately 30 percent of the total rental value of the shopping center. The term of the lease is 20 years, which is substantially all of the remaining economic life of the building. This Example has the following assumptions.

Sales price of shipping center	\$ 3,500,000
Estimated to consist of:	
Land	\$ 1,000,000
Buildings and improvements	<u>2,500,000</u>
	<u>\$ 3,500,000</u>
Carrying value of shopping center	\$ 1,000,000
Monthly rentals called for by leaseback	\$ 12,600
Seller-lessee's incremental borrowing rate ^(a)	10%

(a) Believed to be approximately the same as the implicit rate calculated by the lessor.

840-40-55-87

The seller-lessee estimates the ratio of land to building for the leaseback to be the same as for the property as a whole. The seller-lessee would apply paragraph 840-10-25-38(b)(2)(i) because the land value exceeds 25 percent of the total fair value of the leased property and would account for the leaseback of the land as a separate operating lease. The seller-lessee would account for \$2,500 as monthly land rental (10 percent incremental borrowing rate applied to the \$300,000 value of the land leased back—30 percent of the land value of the shopping center). The balance of the monthly rental (\$10,100) would be allocated to the building and improvements and would be accounted for as a capital lease pursuant to the 75 percent of economic life criterion in paragraph 840-10-25-1(c). The leased building and improvements would be recorded at the present value of the \$10,100 monthly rentals for 20 years at the seller-lessee's 10 percent incremental borrowing rate, or \$1,046,608. The seller-lessee would compute the profit to be recognized on the sale as follows.

Profit on the sale	\$ 2,500,000
Recorded amount of leased asset (capital lease)	\$ 1,046,608
Present value of operating lease rentals at 10% rate	<u>259,061</u>
Profit to be deferred and amortized	<u>1,305,669</u>
Profit to be recognized	<u>\$ 1,194,331</u>

840-40-55-88

The deferred profit would be amortized in relation to the separate segments of the lease. The amount attributable to the capital lease (\$1,046,608) would be amortized in proportion to the amortization of the leased asset over the term of the lease. The amount attributable to the operating lease (\$259,061) would be amortized on a straight-line basis over the term of the lease.

9.4.1 Installment method

If the buyer's initial investment does not meet the criteria specified in ASC 360-20 for recognition of profit by the full accrual method and if recovery of the cost of the property is reasonably assured if the buyer defaults, and the sale is consummated, ASC 360-20-40-31 requires the use of the installment method to account for the sale. Pursuant to ASC 360-20-40-31, the cost recovery method may also be used to account for sales of real estate for which the installment method is appropriate. See ASC 976-605, *Real Estate – Retail Land – Revenue Recognition*, for further information on the application of the installment method to retail land sales.

The installment method apportions each cash receipt and principal payment made by the buyer on debt assumed between cost recovered and profit. The apportionment is in the same proportion as total cost and total profit bear to the sales value. Under the installment method, the receivable less profit not yet recognized should not exceed what the property value would have been if the property had not been sold.

The following example illustrates a sale-leaseback transaction where the sale is recorded under the installment method:

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-49

This Example illustrates that a sale-leaseback transaction that qualifies for sales recognition under the guidance in this Subtopic is accounted for using sale-leaseback accounting by the seller-lessee whether the leaseback is classified as a capital lease or an operating lease in accordance with Subtopic 840-10. The proper approach is first to determine the gain that would be recognized under Subtopic 360-20 as if the transaction were a sale without a leaseback and then to allocate that gain as provided by this Subtopic over the remaining lease term. Under the definition of profit or loss on sale, the gain to be deferred and amortized in proportion to the leaseback is the gain that would otherwise be recognized in that year under the guidance in Subtopic 360-20, except for the amount that can be recognized currently under paragraph 840-40-25-3. The total gain is recognized immediately if the leaseback is considered minor. The gain to be recognized currently under paragraph 840-40-25-3(b) is the amount of gain in excess of:

- a. The present value of the minimum lease payments if the leaseback is classified as an operating lease
- b. The recorded amount of the leased asset if the leaseback is classified as a capital lease.

840-40-55-50

Entity A (a seller-lessee) sells the building at its principal manufacturing facility with an estimated remaining life of 15 years and a cost less accumulated depreciation of \$800,000 to a buyer-lessor for \$950,000 (the fair value of the property as determined by an independent third-party appraisal) and enters into an agreement to lease back the building. In exchange for the building, the seller-lessee receives \$50,000 and a 10-year \$900,000 recourse note with a 10 percent annual interest rate with annual payments of \$146,471. Under the terms of the agreement, the seller-lessee is required to lease the building back for \$100,000 a year for an initial period of 5 years. In addition, the seller-lessee has the option to renew the lease for an additional 5 years at \$110,000 (estimated to be the then fair-market rental).

840-40-55-51

The sale-leaseback transaction does not include any form of continuing involvement that would preclude the seller-lessee from using sale-leaseback accounting. The initial down payment is inadequate for the seller-lessee to account for the transaction under the full accrual method described in Subtopic 360-20. Under the guidance in that Subtopic, the seller-lessee elects to use the installment method to recognize the gain on the transaction. The property and any related debt would be removed from the seller-lessee's balance sheet and the note receivable net of unamortized deferred profit would be reported on the balance sheet. The renewal of the lease is included in the lease term for purposes of classifying the lease and amortizing income because the loss of the property at the end of the initial lease term is considered to be a penalty. The leaseback is classified as an operating lease because none of the criteria of paragraph 840-10-25-1 is met.

840-40-55-52

Recognition of the gain on the transaction is as follows.

Sales price	\$ 950,000
Cost less accumulated depreciation	<u>800,000</u>
Total gain to be recognized	<u>\$ 150,000</u>

Gain recognition under Subtopic 360-20 (Installment Method Absent the Leaseback)

Day 1	\$ 7,895
End of Year 1	8,916
Year 2	9,808
Year 3	<u>123,381</u>
Total	<u>\$ 150,000</u>

Gain Recognition for the Sale-Leaseback under this Subtopic
Allocation of Annual Gain under the Installment Method with the Leaseback

Period recognized	Day 1 gain	End of Year 1 gain	Year 2 gain	Year 3 gain	Total gain recognized
Year 1	\$ 789	\$ –	\$ –	\$ –	\$ 789
Year 2	789	990	–	–	1,779
Year 3	789	990	1,226	–	3,005
Year 4	789	990	1,226	17,625	20,630
Year 5	789	991	1,226	17,626	20,632
Year 6	790	991	1,226	17,626	20,633
Year 7	790	991	1,226	17,626	20,633
Year 8	790	991	1,226	17,626	20,633
Year 9	790	991	1,226	17,626	20,633
Year 10	790	991	1,226	17,626	20,633
Total	<u>\$ 7,895</u>	<u>\$ 8,916</u>	<u>\$ 9,808</u>	<u>\$ 123,381</u>	<u>\$ 150,000</u>

840-40-55-53

Note: The installment method as described in paragraph 360-20-55-7 requires profit to be allocated to the down payment and subsequent collections on the buyer-lessor's note (principal portion only) by the percentage of profit inherent in the transaction (in this Example, 15.79 percent). In addition, paragraph 360-20-55-12 allows a seller to switch from the installment method to the full accrual method of recognizing profit when the transaction meets the requirements for the full accrual method on a cumulative basis. In this Example, it is assumed that for the seller-lessee to recognize profit in Year 3 under the full accrual method, the buyer-lessor must have an investment in the property of 20 percent of the sales price to meet the minimum investment requirement and that the seller-lessee elects to switch to the full accrual method in the first full year after the minimum initial and continuing investment criteria are met.

9.5 Other transactions subject to real estate sale-leaseback accounting

Real estate sale-leaseback accounting guidance also may be applicable to transactions involving real estate that are structured other than as a typical sale and leaseback. Entities may structure transactions differently than a typical sale-leaseback to achieve certain tax treatments, for financing or for other reasons. The following are examples of these transactions.

9.5.1 Contribution-leaseback

Under a contribution-leaseback arrangement, an entity contributes real estate to another entity in exchange for a noncontrolling interest in that entity. Concurrent with the contribution of property, the contributor/transferor enters into an arrangement to leaseback the contributed property. We believe that a contribution-leaseback transaction represents a partial sale-leaseback of real estate that should be accounted for in accordance with the provisions for sale-leaseback transactions involving real estate under ASC 840-40. As discussed in Section 9.2.8, partial sale transactions preclude the use of sale-leaseback accounting. Contribution-leaseback transactions should typically be accounted for as a financing because of the contributor/transferor's continuing involvement with the contributed property.

9.5.2 Spin-off-leaseback

Under a spin-off-leaseback arrangement, an entity distributes the stock of a subsidiary that owns real estate (the real estate may or may not also be leased by other entities in the consolidated group) to the shareholders of the parent entity. Concurrent with the spin-off, the parent entity enters into an arrangement to leaseback all or a portion of the properties that were spun-off. We also believe that a spin-off-leaseback transaction should be accounted for in accordance with the provisions for sale-leaseback transactions involving real estate under ASC 840-40. Accordingly, an entity would only account for a spin-off-leaseback transaction as a sale-leaseback if all the criteria in ASC 840-40-25-9 (see Section 9) are fulfilled.

9.5.3 Exchange-leaseback

Under an exchange-leaseback arrangement, an entity (seller-lessee) typically exchanges real estate with another entity (buyer-lessor) in a non-monetary exchange and leases the real estate back from the buyer-lessor. Similar to contribution and spin-off leaseback transactions, we believe that exchange-leaseback transactions should also be accounted for in accordance with the provisions for sale-leaseback transactions involving real estate under ASC 840-40.

9.6 Impairment of assets subject to a sale-leaseback

A company enters into a sale-leaseback transaction that fails the tests for sale-leaseback accounting and is treated as a financing of the existing asset, which is not removed from the company's balance sheet. A question arises as to whether any excess of carrying amount over fair market value at the date of the sale should be recognized as a loss.

It is our view that an asset that does not qualify for sale-leaseback accounting would be subject to impairment under ASC 360-10. Any significant difference between carrying value and fair market value at the date of sale would indicate that the recoverability of the carrying amount of an asset should be assessed under the guidelines of ASC 360-10. See our Impairment or disposal of long-lived assets FRD for further information on applying the provisions of ASC 360-10.

9.7 Rental shortfall agreements

The following is a description of a rental shortfall agreement. A real estate developer sells a recently constructed office building to a public real estate “blind pool” syndication. Because the property is not yet fully occupied, the general partner of the syndication negotiates a master leaseback agreement with the seller at the date of the sale. Under the terms of the agreement, the syndication pays a fee to the seller and the seller leases the vacant space at a market rate, at the sale date, for a two-year period. This payment is described as a fee in exchange for signing a master lease or as an escrowed portion of the purchase price. The syndication will relieve the seller of its future lease payment obligations on space the seller subsequently subleases to others if the sublease meets certain criteria. If the seller is unable to lease the vacant space during the two-year period, the rental payments to the syndication would substantially exceed the fee paid by the syndication.

ASC 970-360-25-1 addresses how the syndication (buyer-lessor) should account for the fee it pays the seller and the rent it receives from the seller but it does not address the seller-lessee’s accounting. Payments to and receipts from the seller should be treated by the syndication (buyer) as adjustments to the basis of the property and will affect future depreciation (i.e., the lease payments received from the seller should not be recorded as income). In developing the guidance in ASC 970-360-25-1, some EITF members, including the SEC Observer, viewed the payment to the seller as an escrowed portion of the purchase price contingent on the seller’s ability to rent the space (EITF 85-27).

The EITF addressed but was unable to reach a consensus on how rental shortfall agreements should be distinguished from a sale-leaseback transaction. However, the EITF agreed that the following criteria are helpful, but not necessarily conclusive, in identifying rental shortfall agreements that would warrant accounting as an adjustment of the purchase price by the buyer-lessor rather than as a sale-leaseback transaction:

1. The seller receives a fee as an inducement for entering into the lease agreement. (The absence of a fee, however, is not necessarily an indication that the transaction is a sale-leaseback.)
2. The seller’s lease commitment is for a short term, and the seller does not have any renewal options.
3. The seller is relieved of its lease obligation as it obtains tenants for the building.
4. The “subleases” extend beyond the leaseback period. (The “sublease” may be in form a sublease from the seller-lessee over the remaining leaseback period and a separate lease from the buyer for an additional period.)
5. When a building is currently leased up, the seller’s lease commitment merely represents the difference between existing lease rents and market rents over some period.

If the seller-lessee has a firm commitment, is not relieved of its primary obligation as the property is subleased and the agreement is for a longer term, the transaction more closely resembles a sale-leaseback transaction (EITF 84-37).

9.8

Sale-leasebacks by regulated enterprises**Excerpt from Accounting Standards Codification****Leases – Sale-Leaseback Transactions***Scope and Scope Exceptions***840-40-15-4**

The guidance in the Lessees Subsections applies to all entities, including regulated entities subject to Topic 980.

Regulated Operations – Leases*Recognition***980-840-25-1**

Accounting for sale-leaseback transactions in accordance with the guidance in Subtopic 840-40 may result in a difference between the timing of income and expense recognition required by that Subtopic and the timing of income and expense recognition for rate-making purposes.

980-840-25-2

That difference shall be accounted for as follows:

- a. If the difference in timing of income and expense recognition constitutes all or a part of a phase-in plan, it shall be accounted for in accordance with Subtopic 980-340.
- b. Otherwise, the timing of income and expense recognition related to the sale-leaseback transaction shall be modified as necessary to conform to the Regulated Operations Topic. That modification required for a transaction that is accounted for by the deposit method or as a financing is further described in the following paragraph and paragraphs 980-840-35-1 through 35-2.

980-840-25-3

The difference between the amount of income or expense recognized for a transaction that is not part of a phase-in plan and that is accounted for by the deposit method or as a financing under Subtopic 840-40 and the amount of income or expense included in allowable cost for rate-making purposes shall be capitalized or accrued as a separate regulatory-created asset or liability, as appropriate, if that difference meets the criteria of the Regulated Operations Topic.

*Subsequent Measurement***980-840-35-1**

If a sale-leaseback transaction that is not part of a phase-in plan is accounted for by the deposit method but the sale is recognized for rate-making purposes, the amortization of the asset shall be modified to equal the total of the rental expense and the gain or loss allowable for rate-making purposes.

980-840-35-2

Similarly, if the sale-leaseback transaction is accounted for as a financing and the sale is recognized for rate-making purposes, the total of interest imputed under the interest method for the financing and the amortization of the asset shall be modified to equal the total rental expense and the gain or loss allowable for rate-making purposes.

The provisions of ASC 840-40 apply to sale-leaseback transactions of a regulated enterprise subject to ASC 980, *Regulated Operations*. Sale-leaseback accounting under ASC 840-40 may result in a difference between the timing of income and expense recognition for accounting purposes and the timing of income and expense recognition for rate-making purposes.

9.9 Financial statement disclosures – sale-leaseback of real estate

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Disclosure

840-40-50-1

In addition to the disclosure requirements of Subtopics 360-20 and 840-10, the financial statements of a seller-lessee shall include a description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement.

840-40-50-2

The financial statements of a seller-lessee that has accounted for a sale-leaseback transaction by the deposit method or as a financing according to the guidance in this Subtopic also shall disclose both of the following:

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

10 Lessee involvement in asset construction

In build-to-suit lease transactions various forms of lessee involvement during the construction period raise questions about whether the lessee is acting as an agent for the owner-lessor or is, in substance, the owner of the asset during the construction period. In some asset construction arrangements, the prospective lessee participates in the asset construction process. For example, a prospective lessee may act as a construction agent, general contractor or as principal for the owner-lessor during the asset construction period. As part of that involvement, the lessee also may be subject to certain contractual obligations (such as debt guarantees, obligations to fund cost overruns, lease commencement guarantees or obligations to purchase the construction project in certain situations).

10.1 Sale-leaseback transactions due to lessee involvement in asset construction

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Overview and Background

840-40-05-5

A sale-leaseback transaction may arise in situations in which the lessee never owned the leased property. For example, an entity (lessee) may be involved on behalf of an owner-lessor with the construction of an asset that will be leased to the lessee when construction of the asset is completed. Paragraph 840-40-15-5 requires that a lessee be considered the owner of an asset during the construction period, and thus subject to this Subtopic, if the lessee has substantially all of the construction period risks. Various forms of the lessee's involvement during the construction period raise questions about whether the lessee is acting as an agent for the owner-lessor or is, in substance, the owner of the asset during the construction period. The lessee's involvement during the construction period may include any of the following:

- a. Being obligated to begin making lease payments regardless of whether the project is complete (a date-certain lease)
- b. Guaranteeing the construction debt or providing construction financing either directly or indirectly
- c. Being primarily or secondarily obligated on construction contracts
- d. Serving as an agent for the construction, financing, or ultimate sale of the asset for the owner-lessor
- e. Acting as a developer or being the general contractor
- f. Being obligated to purchase the asset if the construction is not successfully completed by an agreed-upon date
- g. Being obligated to fund cost overruns, and so forth.

Those transactions may involve a special-purpose entity that is the owner-lessor of the asset.

Scope and Scope Exceptions**840-40-15-5**

A lessee shall be considered the owner of an asset during the construction period, and thus subject to this Subtopic, if the lessee has substantially all of the construction period risks—effectively a sale and leaseback of the asset occurs when construction of the asset is complete and the lease term begins (see the implementation guidance beginning in paragraph 840-40-55-2).

Lessee involvement in projects where a long-lived asset is constructed may result in sale-leaseback transactions subject to the provisions of ASC 840-40. There is no requirement that the prospective lessee entity serve as a construction agent, general contractor or principal for the owner lessor in the project for sale-leaseback accounting to be applicable. In addition, the provisions that result in a lessee being considered the owner of an asset during the construction period and thus subject to the sale-leaseback provisions of ASC 840-40, are applicable to both real estate projects and projects involving non-real estate assets, for example, the construction of a vessel whereby the lessee has some involvement in the construction process.

10.2**Lessee involvement in asset construction ownership test****Excerpt from Accounting Standards Codification****Leases – Sale-Leaseback Transactions****Implementation Guidance and Illustrations****840-40-55-2**

This implementation guidance addresses the application of paragraph 840-40-15-5, which requires that a lessee be considered the owner of an asset during the construction period, and thus subject to this Subtopic, if the lessee has substantially all of the construction period risks. An evaluation of whether the lessee has substantially all of the construction period risks should be based on a maximum guarantee test that is similar to the 90 percent recovery test in the minimum-lease-payments criterion in paragraph 840-10-25-1(d).

840-40-55-3

Under this approach, a lessee's maximum guarantee includes any payments that the lessee is obligated to make or can be required to make in connection with the construction project.

840-40-55-4

Because build-to-suit real estate projects have generated most of the questions about lessee involvement during the construction period, the guidance that follows is worded to address those projects specifically. However, this guidance applies to all asset construction projects with lessee involvement and is not limited to build-to-suit real estate projects.

840-40-55-5

This guidance also applies to determining whether an entity that has an option to become, or that may be compelled to become, the lessee after construction of the asset is completed should be considered the owner of the asset during the construction period.

840-40-55-6

This guidance does not apply to any entity that is a lessee (or that has an option to become a lessee) under a lease agreement in which the maximum obligation, including guaranteed residual values, represents a minor amount of the asset's fair value.

The existence of an option that allows an entity to become the lessee of the completed project (i.e., by exercising the option) is treated no differently than an arrangement in which an entity is a lessee. Any entity that is a lessee (or that has an option to become a lessee) under a lease agreement under which the maximum obligation, including any guaranteed residual value, represents a “minor” amount (less than 10% of the fair value of the asset – see Sections 8.1.2 and 9.1.1), is not subject to the provisions of sale-leaseback accounting.

If, at any time during the construction period, the present value of the “maximum guarantee” is 90% or more of the total qualifying project costs (see Section 10.3.4) incurred to date or violates any one or more of six “special provisions” (see Section 10.4), then the lessee would be deemed to have substantially all of the construction period risk and would be considered the owner of the build-to-suit project during the construction period for financial reporting purposes.

If the lessee is considered the owner of the asset during the construction period, then a deemed sale-leaseback of the asset would occur when construction of the asset is complete and the lease term begins. Sale and leaseback transactions of real estate assets must meet the restrictive conditions set forth in ASC 840-40 for real estate sale-leasebacks (see Section 9) in order for the lessee to recognize a sale and derecognize the real estate asset when construction of the asset is complete and the lease term begins. Sale-leaseback transactions of assets other than real estate must follow the general sale-leaseback accounting guidance (see Section 8) when accounting for the sale-leaseback of the constructed asset. The remainder of this Section focuses on the maximum guarantee test and the six “special provisions” as discussed in ASC 840-40-55-15 (see Section 10.4).

10.3

Maximum guarantee test

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-8

Except as indicated in the following paragraph and paragraph 840-40-55-15, the maximum guarantee should include, but not be limited to, the following:

- a. Lease payments that must be made regardless of when or whether the project is complete (a date-certain lease)
- b. Guarantees of the construction financing (however, such guarantees can only be made to the owner-lessor as specified in paragraph 840-40-55-15(d))
- c. Equity investments made (or an obligation to make equity investments) in the owner-lessor or any party related to the owner-lessor
- d. Loans or advances made (or an obligation to make loans or advances) to the owner-lessor or any party related to the owner-lessor
- e. Payments made by the lessee in the capacity of a developer, a general contractor, or a construction manager-agent that are reimbursed less frequently than is normal or customary for the real estate construction industry in transactions in which the developer, general contractor, or construction manager-agent are not involved in the project in any other capacity
- f. Primary or secondary obligations to pay project costs under construction contracts
- g. Obligations that could arise from being the developer or general contractor

- h. An obligation to purchase the real estate project under any circumstances
- i. An obligation to fund construction cost overruns
- j. Rent or fees of any kind, such as transaction costs, to be paid to or on behalf of the lessor by the lessee during the construction period
- k. Payments that might be made with respect to providing indemnities or guarantees to the owner-
lessor.

840-40-55-9

The following guidance relates to the application of the maximum guarantee test:

- a. If, in connection with the project, the lessee or any party related to the lessee makes or is required to make an investment in the lessor, or any party related to the lessor, other than investments considered to be in substance real estate as discussed in paragraph 840-40-55-15, the cost of that investment is to be included in the maximum guarantee test. Likewise, if, in connection with the project, the lessee or any party related to the lessee makes or is required to make loans or advances (including making time deposits) to the lessor or any party related to the lessor, other than loans that in substance represent an investment in the real estate project, those loans or advances are to be included in the maximum guarantee test.
- b. If the lessee, in the capacity of a developer, a general contractor, or a construction manager-agent pays or can be required to pay costs relating to the project that are reimbursed less frequently than is normal or customary, those payments are to be included in the maximum guarantee test. Thus, if the lessee can be required to make payments at a time when the owner-
lessor of the project does not have the funds or a committed line of credit available to make the required reimbursements, the maximum payment amount that the lessee could be required to make is included in the maximum guarantee test. For this purpose, a line of credit would not be considered committed if there is a possibility that the reimbursement would not occur because the lender, as a result of a provision in the loan agreement, agency agreement, or other documents pertaining to the transaction, can withhold funds for any reason other than misappropriation of funds or willful misconduct of the owner-
lessor or its agent.
- c. Any guarantee or commitment made to the owner-
lessor by a party related to the lessee should be included in the maximum guarantee test as if that guarantee were made by the lessee unless the owner-
lessor, guarantor, and lessee all are under common control, in which circumstance the guarantee or commitment may be excluded from the maximum guarantee test. Thus, situations in which a private entity (lessee) is controlled by a shareholder that also controls the lessor are not required to consider such guarantees or commitments in performing the maximum guarantee test.
- d. Any indemnification or guarantee of the owner-
lessor against third-party claims relating to construction completion must be included, at its maximum amount, in the maximum guarantee test without regard to the probability of its occurrence.
- e. Total project costs include the amount capitalized in the project by the owner-
lessor in accordance with generally accepted accounting principles (GAAP) plus other costs related to the project paid to third parties other than lenders or owners. For example, cancellation fees that would be payable to subcontractors if the project were to be cancelled before completion would be included in total project costs. Transaction costs that would not be capitalized by the lessor as construction costs in accordance with GAAP, such as a facility fee (that is, a fee paid to establish a master lease facility), are specifically excluded from the definition of total project costs. Consequently, if the lessee were to pay any transaction costs to or on behalf of the lessor at the time the construction arrangement is entered into, the lessee would be considered the owner of

the construction project because that payment by definition would exceed the total project costs incurred to date at that time. Likewise, imputed yield on equity in the project is specifically excluded from the definition of total project costs.

- f. Land acquisition costs should be excluded from project costs for purposes of applying the maximum guarantee test regardless of the land value relative to the overall project value. Land carrying costs, such as interest or ground rentals incurred during the construction period, are considered to be part of total project costs.
- g. A lessee's unlimited obligation to cover costs over a certain amount (for example, an obligation arising from the lessee-general contractor's entering into a fixed-price contract) would result in the lessee's maximum guarantee being in excess of 90 percent of the total project costs. Therefore, the lessee would be considered the owner of the project during the construction period.
- h. Any payments that the lessee could be required to make as a result of cost overruns or change orders should be considered carefully. Payments by the lessee for project costs that are not reimbursed by the owner-lessor will cause the lessee to be considered the owner of the project during the construction period. However, lease payments made during the construction period do not automatically cause the lessee to be considered the owner of the project, although those payments would need to be considered in both the maximum guarantee test and the lease classification test. Payments made by the lessee during the construction period for tenant improvements should be carefully considered. Payments for normal tenant improvements, as described in paragraph 840-40-55-15(b), would not affect either the maximum guarantee or the lease classification tests. Payments for any other tenant improvements (for example, those originally included in amounts to be paid by the lessor) should be treated the same as other cost overruns.
- i. If the lessee is obligated to make payments in either of the following circumstances, those payments should be included in both the maximum guarantee test and the lease classification computation:
 1. The lessee is obligated to make a payment under the lease regardless of whether the construction project is completed (as would be the circumstance in a date-certain lease).
 2. The lessee is required to prepay rent, those payments should be included in both the maximum guarantee test and the lease classification computation.

With respect to the lease classification computation, any lease payments made during the construction period should be accounted for in accordance with the guidance in paragraph 840-10-25-6(d).

- j. The following contingent obligations assumed by the lessee are the only contingent obligations that are to be excluded from the maximum guarantee test:
 1. Permitted environmental indemnities as discussed in paragraph 840-40-55-15(c)
 2. Indemnifying the owner-lessor for permitted third-party damage claims as discussed in paragraph 840-40-55-15(d), other than claims arising directly or indirectly out of the lessee's failure to complete construction or to cause construction to be completed by a specified date (for example, claims brought by lenders to accelerate payment of construction financing)
 3. Claims brought by the owner-lessor relating to fraud, misapplication of funds, illegal acts, or willful misconduct on the part of the lessee
 4. A bankruptcy of the lessee.

All other contingent obligations, including contingent obligations resulting directly or indirectly from the lessee's failure to complete construction (for example, default obligations under the related lease agreement if failure to complete construction is an event of default under the lease), must be included in the maximum guarantee test at their maximum amount without regard to the probability of their occurrence. Lessee obligations that result from the lessee's bankruptcy are to be excluded from the maximum guarantee test only if it is reasonable to assume, based on the facts and circumstances that exist on the date the construction agreements are entered into, that a bankruptcy will not occur during the expected period of construction.

- k. In performing the maximum guarantee test, the lessee must consider each alternative course of action available to the owner-lessor in the event of a lessee default under any applicable construction period agreement. For example, if the owner-lessor can cause the uncompleted project to be sold and trigger the lessee's maximum guarantee payment, or alternatively, activate the lease and enforce its rights thereunder, the lessee must perform the maximum guarantee test assuming that the lessor will select the alternative with the highest cost (as a percentage of total project costs) to the lessee.

840-40-55-10

Beginning with the earlier of the date of lease inception or the date that the terms of the construction arrangement are agreed to, if the documents governing the construction project could require, under any circumstance, that the lessee pay 90 percent or more of the total project costs (excluding land acquisition costs) as of any point in time during the construction period, then the lessee-agent should be deemed to have substantially all of the construction period risks and should be considered to be the owner of the real estate project during the construction period.

840-40-55-11

The assessment is made only once, unless the terms of the underlying documents are changed, but that assessment should test whether, at each point during the construction period, the sum of the following amounts is less than 90 percent of the total project costs incurred to date (excluding land acquisition costs, if any):

- a. The accreted value of any payments previously made by the lessee
- b. The present value of the maximum amount the lessee can be required to pay as of that point in time (whether or not construction is completed).

840-40-55-12

If the test in the preceding paragraph is not met, the lessee will be considered the owner of the real estate project during construction.

840-40-55-13

The lessee also would be permitted to provide guarantees in an amount not exceeding the acquisition cost of the land so long as any unused portion of those guarantees is not available to cover any shortfall in the guarantee of the total project costs. The interest rate used to accrete and discount cash flows in this calculation should be the same rate used by the lessee to discount lease payments for purposes of lease classification if that rate is known. Otherwise, the construction borrowing rate should be used. The probability of the lessee's having to make the payments would not be considered in performing the maximum guarantee test.

840-40-55-14

Consistent with the guidance in this Subtopic, the lessee should not reduce the maximum guarantee amount (that is, the numerator in the maximum guarantee test) for any deferred gain.

The maximum guarantee test during the construction period is similar in many respects to the 90% recoverability test in ASC 840-10-25-1(d) (see Section 3.2). Beginning with the earlier of the date of the inception of the lease (see Section 2.2) or the date that the terms of the construction arrangement are agreed to, if the documents governing the construction project could require, under any circumstances, that the lessee pay 90% or more of the total project costs incurred to date (excluding land acquisition costs – see Section 10.3.5) as of any point in time during the construction period, then the lessee-agent should be deemed to have substantially all of the construction period risks and would be the owner of the real estate project during the construction period.

The maximum guarantee assessment is made only once (unless the terms of the underlying agreements are changed) but that assessment should test whether, at any point during the construction period, the sum of (1) the accreted value of any payments previously made by the lessee and (2) the present value of the maximum amount the lessee could be required to pay as of that point in time (whether or not construction is completed) is less than 90% of the total project costs incurred to date (excluding land acquisition costs, if any – see Section 10.3.5). If the sum of the maximum guarantee calculation equals or exceeds 90% of the qualifying costs incurred to date, the lessee would be considered the owner of the real estate project during construction.

The interest rate used to accrete and discount cash flows in this calculation should be the same rate used by the lessee to discount lease payments for purposes of lease classification under ASC 840-10-25-1(d). In many synthetic lease transactions, the implicit rate (see Section 2.10) determined by the lessor can be calculated by the lessee and, thus, that rate would be used.

The probability of the lessee's having to make any payments is not considered in performing the maximum guarantee test. As a result, even though the payment by the lessee may be deemed to be remote, the maximum amount that could be paid in a worst case or even catastrophic scenario is included in the maximum guarantee test.

In performing the maximum guarantee test, the lessee must consider each alternative course of action available to the owner-lessor in the event of a lessee default under any applicable construction period agreement. For example, if the owner-lessor can cause the uncompleted project to be sold and trigger the lessee's maximum guarantee payment, or alternatively, activate the lease and enforce its rights there under, the lessee must perform the maximum guarantee test assuming that the lessor will select the alternative with the highest cost (as a percentage of total project costs) to the lessee.

10.3.1 **Costs included in the maximum guarantee**

The maximum guarantee should include, but not be limited to, the summation of the following at their maximum amount, without regard to probability:

Date-certain lease and prepaid rent

If the lessee is (a) obligated to make payments under the lease regardless of whether the construction project is completed (as would be the case in a "date-certain" lease) or (b) required to prepay rent, those payments should be included in both the maximum guarantee test (during the construction period) and the lease classification test at the inception of the lease under ASC 840-10-25-1(d) (see Section 3.2).

With respect to the lease classification, any lease payments made during the construction period should be accreted in determining the net present value of lease payments. If lease payments are scheduled to begin at a specific point in time whether or not the project is completed (date-certain lease), and are not limited in accordance with the maximum guarantee, the lessee would be deemed the owner during the construction period as it cannot be assumed that the project will be completed prior to the lease commencing. See Section 10.5 for a discussion of interim rent based on a contingency, as well as significant prepayments of rent (e.g., rent prepaid up to the maximum guarantee).

Guarantees of the construction financing

Guarantees of the construction financing (e.g., borrowings utilized by the owner-lessor) are included in the maximum guarantee test. As a result, if the lessee guarantees construction financing, for the purposes of the maximum guarantee test, it is assumed that the borrower would default on the financing and that the lessee's guarantee would be activated. Because a majority of lessee involvement in asset construction projects are highly leveraged, guarantees of construction financing often violate the maximum guarantee test if appropriate limits are not included in the agreement.

Loans or advances

If, in connection with a construction project, the lessee or any party related to the lessee makes or can be required to make, under any circumstances, loans or advances (including making time deposits) to the lessor or any party related to the lessor, other than loans that in substance represent an investment in the real estate project (investments considered to be in substance real estate are automatic indicators of lessee ownership during the construction period – see Section 10.4), those loans or advances would be included in the maximum guarantee test. (See Section 10.5 for a discussion of deposits by the lessee and their impact on determining the owner of the construction project.)

Reimbursements

If a lessee, in the capacity of a developer, general contractor or construction manager/agent pays or can be required to pay costs relating to the project that are reimbursed less frequently than is normal or customary, those payments are to be included in the maximum guarantee test. Thus, if the lessee can be required to make payments at a time when the owner-lessor of the project does not have the necessary funds or a committed line of credit available to make the required reimbursements, the maximum payment amount that the lessee could be required to make is included in the maximum guarantee test. For this purpose, a line of credit would not be considered "committed" if there is a possibility that the reimbursement would not occur because the lender, as a result of a provision in the loan agreement, agency agreement or other documents pertaining to the transaction, can withhold funds for any reason other than misappropriation of funds or willful misconduct by the owner-lessor or its agent. If the payments were not intended to be reimbursed, this would be considered a violation of one of the "special provisions" of ASC 840-40-55-15 that would have the effect of considering the lessee the owner during the construction period (see Section 10.4).

Obligations to pay project costs

Primary or secondary obligations to pay project costs under construction contracts are to be included in the maximum guarantee test. Although in many instances the lessee will serve as construction agent or general contractor, it is important that the owner of the facility or some third party unrelated to the lessee retains primary and secondary liability for project costs. An obligation to pay hard costs of construction is further discussed in Section 10.4.

General contractor or developer obligations

Obligations that could arise from being the developer or general contractor are to be included in the maximum guarantee test. Obligations associated with being a general contractor or developer include fixed cost construction contracts and completion guarantees. An obligation to pay hard costs of construction is further discussed in Section 10.4.

Real estate acquisition requirements

An obligation to purchase the real estate project under any circumstances is to be included in the maximum guarantee test. As a result, a provision requiring the lessee to purchase the asset during the construction period if not completed by a certain date or if financing is not obtained would require the lessee to include such purchase amount in the maximum guarantee test.

Cost overruns

An obligation to fund construction cost overruns would be included in the maximum guarantee test. A lessee's unlimited obligation to cover costs over a certain amount (for example, an obligation arising from the lessee-general contractor's entering into a fixed-price contract) would result in the lessee's maximum guarantee being in excess of 90% of the total project costs. Therefore, the lessee would be considered the owner of the project during the construction period. Any payments that the lessee could be required to make as a result of cost overruns or change orders should be considered carefully. Payments made by the lessee during the construction period for tenant improvements also should be carefully considered. Payments for normal tenant improvements would not impact either the maximum guarantee or the lease classification tests. Payments for any other tenant improvements (for example, those originally included in amounts to be paid by the lessor) should be treated the same as other cost overruns. An obligation to pay hard costs of construction is further discussed in Section 10.4.

Construction period rent or fees

Rent or fees of any kind, such as transaction costs, to be paid to or on behalf of the lessor (without reimbursements) by the lessee during the construction period are to be included in the maximum guarantee test. Payment of an upfront arrangement or finance fee by the lessee by definition results in payments in excess of eligible project costs incurred to date, resulting in the lessee's maximum guarantee being in excess of 90% of total project costs (see Section 10.3.4). Payments of rent by the project lessee related to land also would be included in the maximum guarantee test.

Indemnities and guarantees

Payments that might be made with respect to providing permitted indemnities (see Section 10.4 for a summary of prohibited indemnities) or guarantees to the owner-lessor are to be included in the maximum guarantee test. Any indemnification or guarantee of the owner-lessor against third-party claims relating to construction completion (for example, default obligations under the related lease agreement if failure to complete construction is an event of default under the lease), must be included, at its maximum amount, in the maximum guarantee test without regard to the probability of its occurrence.

10.3.2

Exclusions from the maximum guarantee test

The following contingent obligations assumed by the lessee are the only contingent obligations that are to be excluded from the maximum guarantee test:

1. Permitted environmental indemnities as discussed in Section 10.4
2. Indemnification of the owner-lessor for permitted third-party damage claims as discussed in Section 10.4 (for example, indemnifications for bodily harm actions brought against the owner-lessor as a result of failure to act by the lessee), other than claims arising directly or indirectly out of the lessee's failure to complete construction or to cause construction to be completed by a specified date (for example, claims brought by lenders to accelerate payment of construction financing)
3. Claims brought by the owner-lessor relating to fraud, misapplication of funds, illegal acts or willful misconduct on the part of the lessee
4. A bankruptcy of the lessee only if it is reasonable to assume, based on the facts and circumstances that exist on the date the construction agreements are entered into, that a bankruptcy will not occur during the expected period of construction

See Section 10.3.5 for a discussion of guarantees of land acquisition costs.

10.3.3 Guarantee by a related party or affiliate

Any guarantee or commitment made to the owner-lessor by a party related to the lessee (see Section 7.1) should be included in the maximum guarantee test as if that guarantee were made by the lessee unless the owner-lessor, guarantor and lessee all are under common control, in which case the guarantee or commitment may be excluded from the maximum guarantee test. This exclusion was adopted primarily to exclude situations in which a private company (lessee) is controlled by a shareholder that also controls the lessor.

10.3.4 Total project costs

Total project costs include the amount capitalized to the project by the owner-lessor in accordance with generally accepted accounting principles (GAAP) plus other costs related to the project paid to third parties other than lenders or owners. For example, cancellation fees that would be payable to subcontractors if the project were to be canceled prior to completion would be included in total project costs. Transaction costs that would not be capitalized by the lessor as construction costs in accordance with GAAP, such as a facility fee (a fee paid to establish a master lease facility), or financing costs are specifically excluded from the definition of total project costs. The only exception is that land rentals during construction are included in project costs even though not capitalizable under GAAP. Consequently, if the lessee were to pay any transaction costs to or on behalf of the lessor at the time the construction arrangement is entered into, the lessee would be considered the owner of the construction project because that payment by definition would exceed the total project costs incurred to date at that time. Imputed yield on equity in the project is specifically excluded from total project costs, because such costs are not capitalizable under ASC 835-20, *Interest – Capitalization of Interest*.

10.3.5 Land acquisition costs

The lessee is permitted to provide guarantees in an amount not exceeding the acquisition cost of the land so long as any unused portion of those guarantees is not available to cover any shortfall in the guarantee of the total project costs. Land acquisition costs should be excluded from project costs for purposes of applying the maximum guarantee test regardless of the land value relative to the overall project value. Land carrying costs, such as interest or ground rentals incurred during the construction period, are project costs.

10.4 Special provisions that result in ownership during the construction period

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-15

A lessee should be considered the owner of a project despite the fact that the present value of the lessee's maximum guarantee is less than 90 percent of the total project costs if, in connection with the project, any of the following conditions exist:

- a. The lessee or any party related to the lessee that is involved with construction on behalf of the owner-lessor makes or is required to make an equity investment in the owner-lessor that is considered in substance an investment in real estate (see paragraph 976-10-15-4 for examples of equity investments that are in substance real estate). In accordance with paragraph 840-40-55-45, the fair value of an option to acquire real property transferred by the lessee to the lessor would be considered a soft cost incurred by the lessee before entering into a lease agreement. In addition, loans made by the lessee during the construction period that in substance represent an

investment in the real estate project, such as those loans discussed in the Acquisition, Development, and Construction Arrangements Subsections of Subtopic 310-10, would indicate that the lessee was the owner of the real estate project during the construction period and therefore would be required to apply this Subtopic.

- b. The lessee is responsible for paying directly (in contrast to paying those costs through rent payments under a lease) any cost of the project other than as follows:
 1. Pursuant to a contractual arrangement that includes a right of reimbursement (regardless of the frequency of reimbursement)
 2. Payment of an environmental cost as described in (c)
 3. Normal tenant improvements. For this purpose, normal tenant improvements exclude costs of structural elements of the project, even though unique to the lessee's purpose, and equipment that would be a necessary improvement for any lessee (for example, the cost of elevators, air conditioning systems, or electrical wiring). A requirement that the lessee pay more of the cost of tenant improvements than originally budgeted for if construction overruns occur could, in effect, obligate the lessee to pay for 90 percent or more of the total project costs. Therefore, normal tenant improvements also exclude any amounts included in the original project budget that the owner-lessor agrees to pay on the date the contract terms are negotiated regardless of the nature of such costs.
- c. The lessee indemnifies the owner-lessor or its lenders for preexisting environmental risks and the risk of loss is more than remote. The lessee should follow the guidance in paragraphs 840-10-25-12 through 25-13 for any indemnification of environmental risks.
- d. Except as permitted by (c), the lessee provides indemnities or guarantees to any party other than the owner-lessor or agrees to indemnify the owner-lessor with respect to costs arising from third-party damage claims other than those third-party claims caused by or resulting from the lessee's own actions or failures to act while in possession or control of the construction project (as is noted in paragraph 840-40-55-9(d) any indemnification of [or guarantee to] the owner-lessor against third-party claims relating to construction completion shall be included in the maximum guarantee test). For example, a lessee may not provide indemnities or guarantees for acts outside or beyond the lessee's control, such as indemnities or guarantees for condemnation proceedings or casualties. If the lessee is acting in the capacity of a general contractor, its own actions or failure to act would include the actions or failure to act of its subcontractors. See the following paragraph for an analysis of the indemnity-guarantee guidance in this Subtopic.
- e. The lessee takes title to the real estate at any time during the construction period or provides supplies or other components used in constructing the project other than materials purchased after lease inception (or the date of the applicable construction agreement, if earlier) for which the lessee is entitled to reimbursement (regardless of the frequency of reimbursement). The costs of any such lessee-provided materials would be considered hard costs (see the guidance beginning in paragraph 840-40-55-42).
- f. The lessee either owns the land and does not lease it or leases the land and does not sublease it (or provide an equivalent interest in the land, for example, a long-term easement) to the owner-lessor before construction commences. If the transaction involves the sale of the land by the lessee to the owner-lessor, that sale would have to occur before construction commences. If the land is sold to the owner-lessor and subsequently leased back with the improvements, the sale of the land would be subject to the requirements of this Subtopic even if the lease of the improvements was not considered to be within the scope of this Subtopic pursuant to this guidance.

A lessee is considered the owner of a construction project during the construction period notwithstanding the fact that the present value of the lessee's maximum guarantee is less than 90% of the total project costs if, in connection with the construction project, any one or more of the following six "special conditions" are met:

1. **Investment in real estate** – A lessee should be considered the owner of a real estate project during the construction period if the lessee or any party related to the lessee that is involved with construction on behalf of the owner-lessor makes, or is required to make, an equity investment in the owner-lessor that is considered in substance an investment in real estate.

Loans made by the lessee during the construction period that in substance represent an investment in the real estate project—such as acquisition, development and construction (ADC) loans—would indicate that the lessee is the owner of the real estate project during the construction period and, therefore, would be required to apply the accounting provisions for real estate sale-leaseback transactions in ASC 840-40. Although ADC transactions have the legal form of loans, they often have the economic substance of a real estate investment or joint venture. ADC transactions may have some or all of the following characteristics:

- ▶ Lender participates in expected residual profits.
- ▶ Lender provides all of the cash flow to acquire and complete the project—including interest added to the loan balance rather than being paid by the borrower.
- ▶ The lender can look only to the property itself to recover the loan—the borrower is not at risk through guarantees or pledging of other collateral; nor are there unconditional contracts with third parties which serve to ensure recovery of the loan.

Typically, the recovery of principal and interest is dependent solely on the sale of the property or obtaining permanent financing from another independent source. In substance, the arrangement is more like an investment or joint venture than a loan, and the required accounting recognition follows that substance. Typically if the lender expects to receive more than 50% of the expected residual profit from the project, then the "loan" is accounted for as a real estate investment (see Section 10.4.2). However, other factors such as those described above could result in similar accounting even if the investment level is lower than 50%.

2. **Lessee pays costs of construction** – A lessee should be considered the owner of a real estate project during the construction period if the lessee is responsible for paying directly (in contrast to paying those costs through rent payments under a lease) any cost of the project other than (a) pursuant to a contractual arrangement that includes a right of reimbursement (regardless of the frequency of reimbursement), (b) an environmental cost as described in item 3 below or (c) "normal tenant improvements." For this purpose, normal tenant improvements exclude costs of structural elements of the project, even though unique to the lessee's purpose, and equipment that would be a necessary improvement for any lessee (for example, the cost of elevators, air conditioning systems or electrical wiring). A requirement that the lessee pay more of the cost of tenant improvements than originally budgeted for if construction overruns occur could, in effect, obligate the lessee to pay for 90% or more of the total project costs. Therefore, normal tenant improvements also exclude any amounts included in the original project budget that the owner-lessor agrees to pay on the date the contract terms are negotiated regardless of the nature of such costs.
3. **Lessee indemnification of preexisting environmental conditions** – A lessee should be considered the owner of a real estate project during the construction period if the lessee indemnifies the owner-lessor or its lenders for preexisting environmental risks and the risk of loss is more than remote. The lessee would need to make this determination at the inception of the lease (see Section 2.2) (before consideration of any recoveries from third parties) pursuant to the indemnification provision based

on enacted environmental laws and existing regulations and policies in determining whether it should be considered the owner of the property. If the likelihood of loss is considered remote, then the existence of the indemnity would not require the lessee to be considered the owner during the construction period. However, if the likelihood of loss is at least reasonably possible (i.e., the chance of occurring is more than remote), then the lessee would be considered to have purchased, sold and then leased-back the property and the transaction would be subject to the provisions for sale-leaseback transactions (ASC 840-40-15-2(a) – see Section 9). A provision that requires lessee indemnifications for environmental contamination caused by the lessee during its use of the property over the term of the lease would not result in the lessee being considered the owner of the project during the construction period.

4. **Lessee indemnities and guarantees** – A lessee should be considered the owner of a real estate project during the construction period if, except as permitted by item 3 above, the lessee provides indemnities or guarantees to any party other than the owner-lessor or agrees to indemnify the owner-lessor with respect to costs arising from third-party damage claims other than those third-party claims caused by or resulting from the lessee's own actions or failures to act while in possession or control of the construction project (as noted previously, any indemnification of (or guarantee to) the owner-lessor against third-party claims relating to construction completion must be included in the maximum guarantee test). For example, a lessee may not provide indemnities or guarantees for acts outside or beyond the lessee's control, such as indemnities or guarantees for condemnation proceedings or casualties or blanket construction period indemnities (e.g., general slip and fall indemnities). Any indemnification by the lessee to any party other than the owner-lessor (e.g., indemnifying lenders other than for environmental matters as discussed in item 3 above, or the individual owner's of the lessor) would be a violation of this provision.

General contractor

If the lessee is acting in the capacity of a general contractor, its own actions or failure to act would include the actions or failure to act of its subcontractors.

Insurance

In addition, a requirement for the lessee to purchase insurance to protect the owner-lessor, without reimbursement, would result in the lessee being considered the owner of the project during the construction period as the expenditures would represent hard costs as discussed in item 5 below. A lessee's obligation to obtain insurance coverage for a project during the construction period is permitted as long as the owner-lessor is the named insured and the lessee does not indemnify the owner-lessor for any deductible or failure of the insurer to make a payment. Any premium payments made by the lessee for the insurance should be reimbursed in the same manner as normal project costs (see Section 10.3.1).

5. **Taking title to real estate and incurrence of "hard costs"** – A lessee is considered the owner of a real estate project during the construction period if the lessee takes title to the real estate at any time during the construction period or provides supplies or other components used in constructing the project other than materials purchased subsequent to the inception of the lease (or the date of the applicable construction agreement, if earlier) for which the lessee is entitled to reimbursement (regardless of the frequency of reimbursement). The costs of any such lessee-provided materials would be considered "hard costs." As a result, if a lessee has incurred nominal construction costs (hard costs) or supplies materials to be used in construction, the lessee would be deemed the owner during the construction period.
6. **Land use** – A lessee should be considered the owner of a real estate project during the construction period if the lessee either owns the land and does not lease it to the lessor or leases the land and does not sublease it (or provide an equivalent interest in the land, for example, a long-term

easement) to the owner-lessor before construction commences. If the transaction involves the sale of the land by the lessee to the owner-lessor, that sale would have to occur before construction commences. If the land is sold to the owner-lessor and subsequently leased back with the improvements, the sale of the land would be subject to the requirements of the accounting provisions for real estate sale-leaseback transactions (see Section 9) even if the lease of the improvements was not considered to be a lease of real estate.

Certain build-to-suit lease transactions are structured with separate leases for the land and the buildings. As discussed previously, any rent paid during the construction period is included in the maximum guarantee test. In addition, if the lessee is leasing the property from the owner during the construction period and does not grant the owner a sublease or other equivalent interest in the property during the construction period, the lessee would be deemed the owner of the project.

10.4.1 Indemnifications and guarantees provided by a lessee

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-16

The following table summarizes the effect of indemnifications and guarantees provided by a lessee in connection with the construction of the leased asset.

	Include in maximum guarantee test	Automatic indication of substantive ownership	No impact on the financial reporting
Indemnities/Guarantees to owner-lessor			
1. Preexisting environmental risk			
a. When risk of loss is remote			X
b. When risk of loss is more than remote		X	
2. Damage claims caused by or resulting from lessee's own actions or failures to act (including third-party claims caused by or resulting from the lessee's own actions or failure to act)			
a. Related to construction completion	X		
b. Not related to construction completion – for example, "slip and fall" claims that occur on the construction site			X
3. Damage claims unrelated to lessee's own actions or failures to act (including third-party claims unrelated to the lessee's own actions or failure to act)		X	
Indemnities/Guarantees to anyone other than owner-lessor			
1. Preexisting environment risk			
a. When risk of loss is remote			X
b. When risk of loss is more than remote		X	
2. Any risk other than preexisting environment risk		X	

10.4.2 Impact of a loan to an SPE – SEC views

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

SEC Materials

840-40-S99-2

The following is the text of the SEC Observer Comment: The Effect of Lessee Involvement in Asset Construction.

With respect to item (1) [paragraph 840-40-55-15(a)] above, the SEC Observer noted that the SEC staff believes that a loan by the lessee to the lessor would be considered an ADC arrangement [Acquisition, Development, and Construction Arrangements] within the scope of Practice Bulletin 1, Exhibit I, whenever the lessee is entitled to participate in the expected residual profit regardless of whether that arrangement is incorporated in the loan, lease, a remarketing arrangement, or other agreement. In addition, the staff believes that a lessee/lender would be considered entitled to participate in the expected residual profit when the lessee holds an option to purchase the leased asset at a fixed price. Paragraph 16(a) of Practice Bulletin 1, Exhibit I, [paragraph 310-10-25-27(a)] specifies that if the [lender/lessee] is expected to receive over 50 percent of the expected residual profit, the [lender/lessee's] loan would, in substance, represent an investment in real estate. Paragraph 16(b) [paragraph 310-10-25-27(b)] specifies that if the [lender/lessee] is expected to receive 50 percent or less of the expected residual profit, the classification of the loan would depend on the circumstances. That paragraph notes that at least one of the characteristics identified in paragraphs 9(b) through 9(e) of Practice Bulletin 1 [paragraph 310-10-25-20(b) through (e)] or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan and not as an investment in real estate. The characteristic identified in paragraph 9(b) [paragraph 310-10-25-20(b)] is that the borrower has an equity investment, substantial to the project, not funded by the lender. The SEC Observer stated that the SEC staff will look to the guidance provided in Appendix A of Statement 66 [paragraphs 360-20-55-1 through 55-2] for determining whether the borrower has a sufficient equity investment. It was observed that leases within the scope of this Issue involving special-purpose entities as lessors generally contain a fixed-price purchase option or a remarketing agreement in which the lessee is entitled to a majority of the sales proceeds in excess of the original cost of the leased asset when it is sold. Thus, the existence of either of those provisions when the lessee has made a loan to the lessor during the construction period would cause the lessee to be considered the owner of the real estate project as specified above.

In commenting on the guidance surrounding lessee involvement in asset construction, the SEC Observer to the EITF noted that the SEC staff believes that a loan by the lessee to the lessor would be considered an ADC arrangement whenever the lessee is entitled to participate in the expected residual profit regardless of whether that arrangement is incorporated in the loan, lease, a remarketing arrangement or other agreement. In addition, the SEC staff believes that a lessee/lender would be considered entitled to participate in the expected residual profit when the lessee holds an option to purchase the leased asset at a fixed price. The SEC Observer stated that the SEC staff will look to the guidance for minimum initial investments for sales of real estate to be accounted for by the full accrual method (ASC 360-20-55-1 through 55-2) for determining whether the borrower has a sufficient equity investment. It was observed that leases in which lessees are involved in asset construction and special-purpose entities are lessors generally contain a fixed-price purchase option or a remarketing agreement in which the lessee is entitled to a majority of the sales proceeds in excess of the original cost of the leased asset when it is sold. Thus,

the existence of either of those provisions when the lessee has made a loan to the lessor during the construction period would cause the lessee to be considered the owner of the real estate project as specified above.

10.5 Other issues

Contingent rent during construction period

In certain transactions, prepaid rent, although subject to the maximum guarantee test, is contingent on some future event (e.g., casualty or condemnation, expiration of loan financing, etc.) and is essentially used to provide greater assurance that financial resources are available to complete the project. These arrangements have been viewed as a form of support extended to the owner-lessor, similar to making an investment in the owner-lessor that is prohibited under ASC 840-40-55-15(a) (see Section 10.4) and results in the lessee being considered the owner of the project during construction.

Prepaid rent

Certain build-to-suit lease transactions require interim rent to be paid during the construction period. In extreme cases, the requirement to prepay rents equates to funding a substantial portion of the construction financing (e.g., of up to 89% of project costs incurred to date). Although within the limits of the maximum guarantee test, the payment of a disproportionate amount of rent during the construction period might be viewed as making an investment in the project – prohibited under ASC 840-40-55-15(a) (see Section 10.4). As a result, payments of interim rent that appear unusually high should be considered carefully. (See also Section 9.2.13 for similar issues related to real estate sale-leaseback transactions).

Land rental

Some build-to-suit lease transactions involve land owned by the lessee-agent that is leased to the owner-lessor of the construction project for the construction period and the entire useful life of the improvement. Recently, we have seen several proposed transactions in which the lessee-agent would receive a nominal amount of rent for the land during the construction period. In our view, any lease of land by the lessee-construction agent to the owner-lessor would have to be at fair market value with normal payment terms. Failure to structure the land lease in this manner would result in the lessee-construction agent being deemed the owner of the construction project during the construction period.

Collateral deposits

Some build-to-suit transactions require the lessee to make a collateral deposit either with the lessor, the lender or with a third party. In our view, unless the deposit is placed with a third party (e.g., not the lessor, the owner of the lessor, the lender to the lessor or any affiliate of these parties), the collateral would be viewed as a prohibited form of support, resulting in the lessee being the owner of the project during construction. If the deposit is placed with a third party, appropriate limitations would have to be placed on whom and under what circumstances anyone can attach the deposit so that the deposit does not violate the maximum guarantee or “special provisions” discussed in Sections 10.3 and 10.4.

Sharing of proceeds

In a build-to-suit transaction, termination of the project prior to construction completion in many instances involves the payment by the lessee of the maximum recourse amount. A build-to-suit lease transaction’s proceeds sharing arrangement should be structured such that prior to the owner-lessor recovering costs, other than eligible project costs (e.g., force majeure costs), the lessee be reimbursed for any payments made under the maximum guarantee. The following illustration demonstrates the sharing of proceeds.

Illustration 10-1: Sharing of proceeds**Scenario A**

Eligible project costs incurred to date	\$ 100
Maximum guarantee of the lessee	\$ 89
Other costs incurred by the owner-lessor excluded from project costs	\$ 5
Proceeds on sale	\$ 101

In this example, assuming the agreements require an allocation of proceeds on sale, the proceeds would be allocated as follows (assumes lessee previously paid the maximum guarantee to the owner-lessor):

Proceeds paid to lessee	\$ 89
Proceeds to owner-lessor	<u>12</u>
Total proceeds	<u>\$ 101</u>

As a result the lessor only recovers \$1 of other costs.

Scenario B

Eligible project costs incurred to date	\$ 100
Maximum guarantee paid by lessee	\$ 89
Other costs incurred by the owner-lessor excluded from project costs	\$ 5
Proceeds on sale	\$ 150

In this example, assuming the agreements require an allocation of proceeds on sale, the proceeds would be allocated as follows (assumes lessee has previously paid the maximum guarantee to the owner-lessor):

Proceeds paid to lessee	\$ 89
Proceeds to owner-lessor	<u>61</u>
Total proceeds	<u>\$ 150</u>

As a result the lessor recovers all of its investment and additional proceeds. In this example, the lessor and lessee may have agreed to share the additional proceeds after the lessee is reimbursed for the maximum guarantee in any manner agreed to.

Scenario C

Eligible project costs incurred to date	\$ 100
Maximum guarantee paid by lessee	\$ 89
Other costs incurred by the owner-lessor excluded from project costs	\$ 5
Proceeds on sale	\$ 70

In this example, assuming the agreements require an allocation of proceeds on sale, the proceeds would be allocated as follows (assumes lessee has previously paid the maximum guarantee to the owner-lessor):

Proceeds paid to lessee	\$ 59
Proceeds to owner-lessor	<u>11</u>
Total proceeds	<u>\$ 70</u>

In this example the lessor is only able to recover \$100 (the maximum guarantee amount).

Costs incurred by lessee prior to entering into a lease agreement including purchase options

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-42

In some build-to-suit lease transactions, the lessee may incur certain development costs before entering into a lease agreement with the developer-lessor. Those costs may include both soft costs (for example, architectural fees, survey costs, and zoning fees) and hard costs (for example, site preparation, construction costs, and equipment expenditures).

840-40-55-43

A lessee who commences construction activities would recognize the asset (construction in progress) on its balance sheet, and any subsequent lease arrangement would be within the scope of this Subtopic.

840-40-55-44

Construction activities have commenced if the lessee has performed any of the following activities:

- a. Begun construction (broken ground)
- b. Incurred hard costs (no matter how insignificant the hard costs incurred may be in relation to the fair value of the property to be constructed)
- c. Incurred soft costs that represent more than a minor amount of the fair value of the leased property (that is, more than 10 percent of the expected fair value of the leased property).

840-40-55-45

In a build-to-suit lease, if a lessee transfers an option to acquire real property that it owns to the lessor, the fair value of the option is included in incurred soft costs.

840-40-55-46

Off-balance-sheet purchase commitments, if at market, would not be considered incurred costs for purposes of the above tests.

840-40-55-47

If a lessee commences construction activities before the involvement of the lessor, the lessee is considered the owner of the project, and the entire transaction would be evaluated as a sale-leaseback under this Subtopic. If the transaction qualifies as a sale under this Subtopic and—if the transaction involves real estate, property improvements, or integral equipment—Subtopic 360-20, the sale would be recognized and profit or loss would be recognized in accordance with the requirements of this Subtopic. If the transaction fails to qualify for sale-leaseback accounting under this Subtopic, the amounts previously expended by the lessee would continue to be reported as construction in progress in the lessee's financial statements, and the proceeds received from the lessor would be reported as a liability. Additional amounts expended by the lessor to fund construction would be reported by the lessee as construction in progress and as a liability to the lessor. Once the property is placed in service, the property would be depreciated and the lease payments would be accounted for as debt service payments on the liability.

A lessee may incur costs for development, either “soft costs” (e.g., architectural fees, survey costs and zoning fees) and/or “hard costs” (e.g., site preparation, construction costs and equipment expenditures) prior to entering into a lease agreement with a developer-lessor. A lessee that commences construction activities would recognize the asset (construction in-progress) on its balance sheet, and any subsequent lease arrangement would be subject to the accounting provisions for real estate sale-leaseback transactions (see Section 9). Construction activities have commenced if the lessee has (1) begun construction (broken ground), (2) incurred hard costs (no matter how insignificant the hard costs incurred may be in relation to the fair value of the property to be constructed) or (3) incurred soft costs that represent more than a minor amount of the fair value of the leased property (that is, more than 10% of the expected fair value of the leased property). In a build-to-suit lease, if a lessee transfers an option to acquire real property that it owns to a lessor, for no consideration, the fair value of the option is included in incurred soft costs.

Currently two views exist in practice regarding deposits (either refundable or non-refundable) made by the lessee. One view equates a deposit to an option and uses the same soft cost significance test (wherein the amount of the deposit is equated to the fair value of an option) in determining whether the lessee is the owner of the property. An alternative view is that a deposit is legally different from an option and, as a result, it is viewed as a hard cost of construction. We believe that if by the terms of the agreement the lessee can be compelled to purchase the asset, it is a hard cost. If however, the agreement provides that the lessee can choose not to purchase the assets and suffer no consequence other than forfeiture of monies paid, we believe the deposit is more like an option and, therefore, considered a soft cost.

Off-balance-sheet purchase commitments (e.g., outstanding purchase orders for work not yet performed or for materials for which title has not yet transferred), if at market, would not be considered incurred costs for purposes of the above tests.

If the transaction qualifies as a sale under the accounting requirements for a sale-leaseback transaction (see Section 8.1) and the sale of real estate and real estate sale-leaseback accounting requirements (see Section 9), if applicable, a sale would be recognized and profit or loss would be recognized in accordance with the applicable requirements. If the transaction fails to qualify for sale-leaseback accounting, the amounts previously expended by the lessee would continue to be reported as construction in-progress in the lessee’s financial statements, and the proceeds received from the lessor would be reported as a liability. Additional amounts expended by the lessor to fund construction would be reported by the lessee as construction in-progress and as a liability to the lessor. Once the property is placed in service, the property would be depreciated and the lease payments would be accounted for as debt service payments on the liability.

10.6 Lessee profit during the construction period

Any profit realized by the lessee during the construction period (for example, rental income paid to the lessee during the construction period under a ground lease or fees paid for construction or development services) when the lessee is involved in asset construction should be deferred and amortized to income over the lease term. The lessee should not reduce the maximum guarantee amount (that is, the numerator in the maximum guarantee test) for any deferred gain. In addition, an entity that may become the lessee as a result of the exercise of an option following construction completion should defer any profit realized during the construction period until the option expires, or until the lease begins (at which point it would be amortized over the lease term) (ASC 840-40-25-4 – see Section 8).

10.7 Construction of government-owned properties subject to a future lease of the completed improvements

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Scope and Scope Exceptions

840-40-15-2

The guidance in this Subtopic may or may not apply to the following transactions:

- a. [ASC 840-40-15-2(a) is included in Section 9.]
- b. The construction of government-owned properties subject to a future lease of the completed improvements shall be evaluated to determine whether the lessee shall be considered the owner of the asset under construction (see paragraphs 840-40-55-2 through 55-16) and otherwise shall account for the arrangement as a sale-leaseback in accordance with this Subtopic.

The construction of government-owned properties (e.g., airport terminals, rest areas, defense facilities) subject to a future lease of the completed improvements should be evaluated to determine whether the lessee should be considered the owner of the asset under construction. Accordingly, if the lessee is deemed to have substantially all of the construction period risks as described throughout this Section, the lessee should be considered the owner of the property for accounting purposes, with the subsequent sale-leaseback accounted for pursuant to the accounting provisions for real estate sale-leaseback transactions.

11

Accounting for sale of tax benefits

Excerpt from Accounting Standards Codification

Leases – Sale-Leaseback Transactions

Implementation Guidance and Illustrations

840-40-55-29

A U.S. entity purchases a depreciable asset and enters into an arrangement with a foreign investor that provides the foreign investor with an ownership right in, but not necessarily title to, the asset. That ownership right enables the foreign investor to claim certain benefits of ownership of the asset for tax purposes in the foreign tax jurisdiction.

840-40-55-30

The U.S. entity also enters into an agreement in the form of a leaseback for the ownership right with the foreign investor. The lease agreement contains a purchase option for the U.S. entity to acquire the foreign investor's ownership right in the asset at the end of the lease term.

840-40-55-31

The foreign investor pays the U.S. entity an amount of cash based on an appraised value of the asset. The U.S. entity immediately transfers a portion of that cash to a third party, and that third party assumes the U.S. entity's obligation to make the future lease payments, including the purchase option payment. The cash retained by the U.S. entity is consideration for the tax benefits to be obtained by the foreign investor in the foreign tax jurisdiction. The U.S. entity may agree to indemnify the foreign investor against certain future events that would reduce the availability of tax benefits to the foreign investor. The U.S. entity also may agree to indemnify the third party trustee against certain future events.

840-40-55-32

The result of the transaction is that both the U.S. entity and the foreign investor have a tax basis in the same depreciable asset.

840-40-55-33

The timing of income recognition for the cash received by the U.S. entity should be determined based on individual facts and circumstances. Immediate income recognition is not appropriate if there is more than a remote possibility of loss of the cash consideration received due to indemnification or other contingencies.

840-40-55-34

The total consideration received by the U.S. entity is compensation for both the tax benefits and the indemnification of the foreign investor or other third-party trustee. The recognition of a liability for the indemnification agreement at inception in accordance with the guidance in Topic 460 would reduce the amount of income related to the tax benefits that the seller-lessee would recognize immediately when the possibility of loss is remote.

Periodically, a company enters into transactions that are, in substance, sales of tax benefits through tax leases. These transactions are commonly referred to as “double-dip” transactions as their objective is to provide to more than one entity a deduction in separate tax jurisdictions (e.g., Switzerland and the U.S.). The transaction generally involves the sale of a depreciable asset or an interest in an asset (or through a sales-type lease – commonly referred to as a “head lease”), to an investor in a foreign jurisdiction in consideration for cash proceeds and an obligation by the seller to lease back the asset under a capital or operating lease.

The foreign investor is typically provided with an ownership right in, but not necessarily with title to, the asset. That ownership right enables the foreign investor to claim certain tax benefits associated with the ownership of the asset such as accelerated depreciation deductions or tax credits. The U.S. entity generally maintains a purchase option to acquire the foreign investor’s rights in the asset at the end of the lease term.

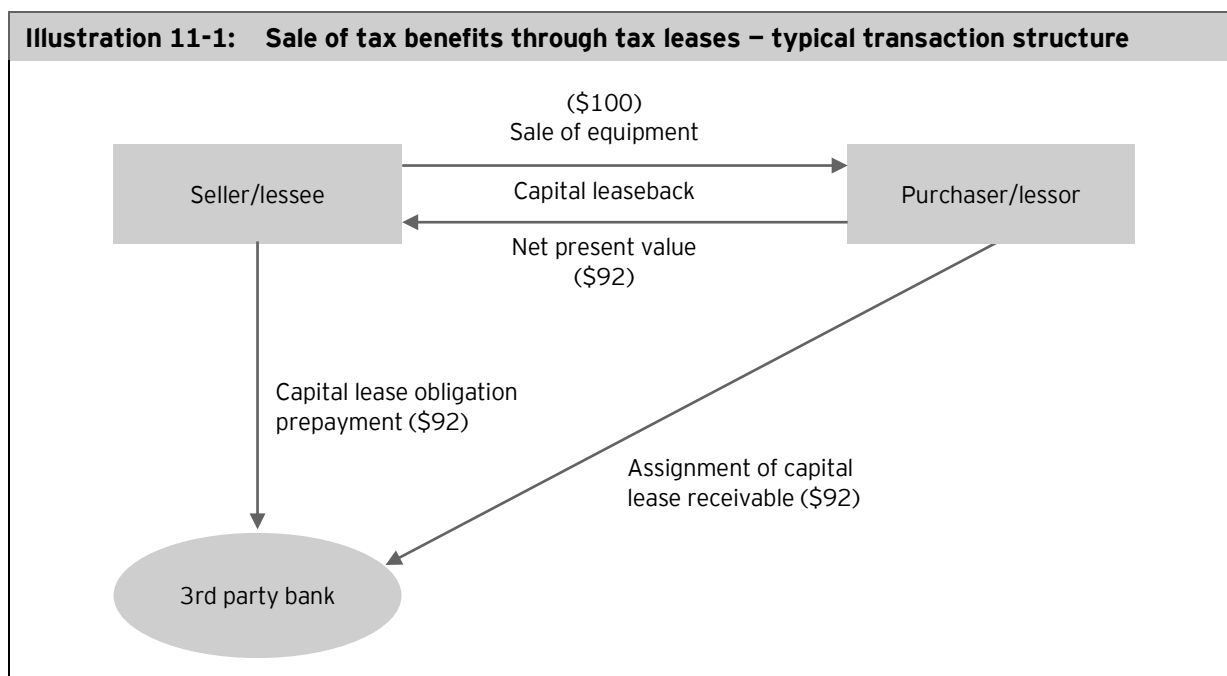
Typically most of the cash proceeds from the sale (or the head lease) are deposited into an essentially risk-free investment trust account, generally managed by a third-party. The earnings and principal of the account are used solely for, and are sufficient to, satisfy the seller-lessee obligation. The free cash (the difference between the sales proceeds and the deposit to the trust account) represents the consideration paid by the investor for the tax benefits. The arrangement often contains indemnification provisions, indemnifying the foreign investor against certain future events that would reduce the availability of tax benefits and/or the third-party trustee against certain future events.

A key determination in accounting for an economic sale of tax benefits is whether it is a sale of tax benefits for accounting purposes. In order to be considered a sale of tax benefits for accounting purposes the capital or the operating lease obligation (leaseback) between the seller-lessee and the buyer-lessor must be considered extinguished under ASC 405-20, *Liabilities – Extinguishments of Liabilities*. To meet the extinguishment requirements of ASC 405-20, the seller-lessee should be legally released as the primary obligor under the capital lease or purchase obligation. Often, as a result of failure to meet the debt extinguishment requirements of ASC 405-20, the capital lease obligation or purchase obligations and the corresponding assets are recorded on the books of the seller-lessee.

Furthermore, as defeasance of the lease or purchase obligation could jeopardize the tax benefits purchased by the lessor, many economic sales of tax benefits are treated as a sale-leaseback for accounting purposes with profit recognized ratably over the leaseback period as described in Section 8.

If however, the leaseback obligation is in fact extinguished, the transaction can be treated as a sale of tax benefits for accounting purposes. Then, a determination should be made whether the consideration received by the U.S. entity for the sale of the tax benefits (net of related costs) should be recognized currently in income, or deferred (this determination applies only to the portion of the gain associated with the sale of tax benefits).

The timing of income recognition of the compensation paid to the seller-lessee for the sale of income tax benefits should be determined based on individual facts and circumstances. Immediate income recognition is not appropriate if there is more than a remote possibility of loss of the cash consideration received by the seller (e.g., due to indemnification or other contingencies that could require the seller of the tax benefits to make payment to the purchaser or to the third party trustee). The following is a graphic depiction of a typical structure (similar objectives are also often achieved through the use of a lease in (head lease), lease out structure (LILO)):



11.1

Disclosure of sale or purchase of tax benefits through tax leases

The following is a summary of the disclosure requirements for a sale or purchase of tax benefits through tax leases:

- ▶ **Significant accounting policies** – The accounting policies or practices followed should include the method of accounting for sale or purchase of tax benefits transactions and the methods of recognizing revenue and allocating income tax benefits and asset costs to current and future periods.
- ▶ **Income taxes** – The reported amount of income tax expense attributable to continuing operations should be reconciled to the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations and the estimated amount and the nature of each significant reconciling item should be disclosed (ASC 740-10-50). Transactions involving the sale or purchase of tax benefits through tax leases may give rise to a significant reconciling item that should be disclosed pursuant to these requirements.
- ▶ **Material transactions** – If material and unusual or infrequent to the enterprise, the nature and financial effects of transactions involving the sale or purchase of tax benefits through tax leases should be disclosed on the face of the income statement or, alternatively, in notes to the financial statements in accordance with ASC 225-20, *Income Statement – Extraordinary and Unusual Items*.
- ▶ **Contingencies** – If significant contingencies exist with respect to the sale or purchase of tax benefits, disclosures in accordance with ASC 450, *Contingencies*, may be warranted.
- ▶ **Comparability** – If comparative financial statements are presented, disclosure should be made of any change in practice that significantly affects comparability.

12 Subleases

12.1 Accounting and reporting for sublease and similar transactions

Excerpt from Accounting Standards Codification

Sublease

A transaction in which a 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.

Subleases are transactions in which an asset is leased (the “Original Lease”) by a lessor (the “Original Lessor”) to a lessee (the “Original Lessee”) and then the same asset is leased (the “Sublease”) by the original lessee to a third party (the “New Lessee”). In some instances the sublease is a separate lease agreement while in other cases the Sublease essentially transfers the existing lease to the third party (but the Original Lessee remains as the primary obligor under the Original Lease).

12.2 Accounting by the original lessor

Excerpt from Accounting Standards Codification

Leases – Overall

Subsequent Measurement

840-10-35-10

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.

Derecognition

840-10-40-3

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 840-30-40-7 and shall classify and account for the new lease as a separate transaction.

No accounting recognition is necessary for the Original Lessor, even if the original lessee transfers the lease to a new lessee, unless the original lease agreement is replaced by a new agreement with a new lessee, in which case the agreement is terminated and the new lease is treated as a separate transaction (see Sections 5.1.4, 5.2.2 and 5.3.4 – 5.3.6 for guidance on accounting for revisions and terminations of leases).

12.3 Accounting by the original lessee

Excerpt from Accounting Standards Codification

Leases – Overall

Derecognition

840-10-40-2

If the nature of a sublease is such that the original lessee is relieved of the primary obligation under the original lease, the transaction shall be considered a termination of the original lease agreement.

Leases – Operating Leases

Recognition

840-20-25-14

If the nature of a sublease is such that the original lessee is not relieved of the primary obligation under the original operating lease, the original lessee (as sublessor) shall account for both the original lease and the new lease as operating leases.

840-20-25-15

If costs expected to be incurred under an operating sublease (that is, executory costs and either amortization of the leased asset or rental payments on an operating lease, whichever is applicable) exceed anticipated revenue on the operating sublease, a loss shall be recognized by the sublessor.

Derecognition

840-20-40-1

Subleases in which the original lessee is not relieved of the primary obligation under the original operating lease are addressed in paragraph 840-20-25-14. If, under the guidance in paragraph 840-10-40-2, a sublease is a termination of the original lease and the original lessee is secondarily liable, the guarantee obligation shall be recognized in accordance with paragraph 405-20-40-2.

Leases – Capital Leases

Subsequent Measurement

840-30-35-12

A sublease in which the original lessee is relieved of the primary obligation under the original capital lease is addressed in paragraph 840-30-40-5. If the nature of a sublease is such that the original lessee is not relieved of the primary obligation under the original capital lease, the original lessee (as sublessor) shall account for the sublease as follows:

- a. The obligation related to the original capital lease shall continue to be accounted for as before.
- b. If the original capital lease met either the transfer-of-ownership criterion in paragraph 840-10-25-1(a) or the bargain-purchase-option criterion in paragraph 840-10-25-1(b), the original lessee (as sublessor) shall classify the new lease in accordance with the criteria in both paragraphs 840-10-25-1 and 840-10-25-42 and do either of the following:
 1. If the new lease meets any of the four criteria in paragraph 840-10-25-1 and both of the criteria in paragraph 840-10-25-42, it shall be classified by the original lessee (as sublessor) as a sales-type or direct financing lease (as appropriate under the criteria in those paragraphs), accounted for according to the guidance in this Subtopic applicable to a lessor, and the unamortized balance of the asset under the original capital lease shall be treated as the cost of the leased property.

2. If the new lease does not qualify as a sales-type or direct financing lease, it shall be accounted for by the original lessee (as sublessor) as an operating lease according to the guidance in Subtopic 840-20 applicable to a lessor.
- c. If the original capital lease met either the lease-term criterion in paragraph 840-10-25-1(c) or the minimum-lease-payments criterion in paragraph 840-10-25-1(d) but did not meet the transfer-of-ownership criterion or the bargain-purchase option criterion, the original lessee (as sublessor) shall, with one exception, classify the new lease in accordance with the lease-term criterion and the criteria in paragraph 840-10-25-42 only. If the new lease meets the lease-term criterion and both of the criteria in paragraph 840-10-25-42, the new lease shall be accounted for by the original lessee (as sublessor) 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, the original lessee (as sublessor) shall account for the new lease as an operating lease in accordance with the guidance in Subtopic 840-20 applicable to a lessor. The one exception arises if the timing and other circumstances surrounding the sublease 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 circumstance, the sublease shall be classified by the original lessee (as sublessor) according to the lease-term criterion and the minimum-lease-payments criterion and both the criteria in paragraph 840-10-25-42. In applying the minimum-lease-payments criterion, the fair value of the leased property shall be the fair value to the original lessor at the inception of the original capital lease.

840-30-35-13

The original lessee (as sublessor) shall recognize a loss on a direct financing sublease if the carrying amount of the investment in the sublease exceeds the total of rentals expected to be received and estimated residual value unless, as sublessor, the original lessee's tax benefits from the transaction are sufficient to justify that result.

Derecognition

840-30-40-5

Subleases in which the original lessee is not relieved of the primary obligation under the original capital lease are addressed in paragraph 840-30-35-12. If, under the guidance in paragraph 840-10-40-2, a sublease is a termination of the original lease, it shall be accounted for by the lessee 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 difference, and, if the original lessee is secondarily liable, the guarantee obligation shall be recognized in accordance with the guidance in paragraph 405-20-40-2. 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 guidance in Subtopic 360-20. If the criteria for recognition of a sale in that Subtopic 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 guidance in (a) for property other than real estate. If the transaction results in a gain, that gain may be recognized by the lessee if the criteria in Subtopic 360-20 for recognition of profit by the full accrual method are met. Otherwise, the gain shall be recognized by the lessee in accordance with one of the other profit recognition methods discussed in that Subtopic. Any loss on the transaction shall be recognized by the lessee immediately.

12.3.1 Original lessee – relieved of primary obligation – not a sublease

If the original lease is an operating lease and the Original Lessee is relieved of primary obligation under the original lease, the transaction is not a sublease. Instead, any consideration paid or received is included in the gain or loss on termination of the original lease (see Section 4.3.10 for accounting for lease termination costs in connection with an exit or disposal activity). If the Original Lessee remains secondarily liable for an operating lease, the guarantee obligation is recognized in accordance with the provisions for extinguishments of liabilities in ASC 405-20-40-2 (i.e., measured at fair value and included in the determination of gain or loss on lease termination).

When the Original Lessee is relieved of the primary obligation for a capital lease of property other than real estate (including integral equipment), the asset and obligation are removed from the accounts. A gain or loss for the difference, and any consideration paid or received on termination, is recognized on termination of the original lease. If the Original Lessee remains secondarily liable for a capital lease, the guarantee obligation is recognized in accordance with the provisions for extinguishments of liabilities in ASC 405-20-40-2 (i.e., measured at fair value and included in the determination of gain or loss on lease termination).

When the Original Lessee is relieved of the primary obligation for a capital lease of real estate (including integral equipment), the provisions for accounting for sales of real estate in ASC 360-20 should be evaluated to determine whether the asset under capital lease and the related obligation should be derecognized by the Original Lessee. If the criteria for recognition of a sale of real estate in ASC 360-20 are met, the asset and obligation representing the original lease should be removed from the Original Lessee's accounts and any consideration paid or received on termination and any secondary obligation would be recognized in manner similar to non-real estate property as described in the preceding paragraph. If the transaction results in an overall gain, the gain would be recognized based on the profit recognition criteria in ASC 360-20 (i.e., full accrual, deposit method or one of the other profit recognition methods provided under ASC 360-20-40). Any loss on the transaction should be recognized immediately.

12.3.2 Original lessee – not relieved of primary obligation – a sublease

When the Original Lessee retains the primary obligation, the transaction is a sublease. When the Original Lessee retains the primary obligation for a capital lease, the accounting for the obligation for the original lease is not affected. If the new lease qualifies to be accounted for as a sales-type or direct financing lease, the unamortized balance of the asset becomes the cost of the asset being subleased. If the original lease was a capital lease because title transferred or it contained a bargain purchase option (see Section 2.4), the sublease would be classified according to the criteria for all leases (i.e., the lease classification criteria discussed in Section 3). If the original lease was classified as a capital lease but did not transfer ownership or contain a bargain purchase option, only the 75% of economic life test would be considered for purposes of classifying the sublease. However, if the timing and other circumstances suggest the original lease was only an intermediate transaction, the 90% of fair value test also should be considered, with the fair value being the original fair value of the leased asset. If the sublease fails to meet the tests for sales-type or direct financing leases, or if the original lease was classified as an operating lease, the sublease should be classified as an operating lease.

12.3.3 Accounting for a loss on a sublease

When an entity enters into a sublease that will result in a loss, the loss should be recorded when the sublease is executed (see Section 4.3.10 for further discussion on the accounting for the costs to terminate an operating lease). The following is a summary of the guidance for determining losses on subleases:

- ▶ **Operating sublease** – If costs expected to be incurred under an operating sublease (executory costs and either amortization of the leased asset or rental payments on an operating lease, whichever is applicable) exceed anticipated revenue on the operating sublease, a loss should be recognized by the sublessor in the period it executed the sublease. The provision for a loss on a sublease would be based on the net expected future cash disbursements.
- ▶ **Direct financing sublease** – A loss should be recognized if the carrying amount of the investment in the sublease (asset under capital lease less capital lease obligation) exceeds the total of rentals expected to be received and estimated residual value that would accrue to the sublessor unless the sublessor's tax benefits from the transaction are sufficient to justify not recording a loss on sublease.
- ▶ **Sales-type sublease** – The normal profit or loss recognition for sales-type leases as prescribed by ASC 840-30-25 applies.

12.4 Accounting by the new lessee

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-32

The lessee in a sublease shall classify the lease in accordance with the four lease classification criteria in paragraph 840-10-25-1 and account for it accordingly.

The New Lessee accounts for the lease in the same manner as any other lease transaction, that is, as a new lease subject to evaluation as operating or capital in accordance with ASC 840-10-25-1 (see Section 3.2).

13

Business combinations

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-27

In a business combination or an acquisition by a not-for-profit entity, the acquiring entity shall retain the previous classification in accordance with this Subtopic for the leases of an acquired entity unless the provisions of the lease are modified as indicated in paragraph 840-10-35-5. That paragraph addresses the accounting for a lease modification that was planned at the time of a business combination but made after the acquisition date.

Subsequent Measurement

840-10-35-5

The classification of a lease in accordance with the criteria in this Subtopic shall not be changed as a result of a business combination or an acquisition by a not-for-profit entity unless the provisions of the lease are modified. At the acquisition date, an acquirer may contemplate renegotiating and modifying leases of the business or nonprofit activity acquired. Modifications made after the acquisition date, including those that were planned at the time of the business combination, are postcombination events that shall be accounted for separately by the acquirer in accordance with the provisions of this Topic. If in connection with a business combination or an acquisition by a not-for-profit entity the provisions of a lease are modified in a way that would require the revised agreement to be considered a new agreement under the preceding paragraph, the new lease shall be classified by the combined entity according to the criteria set forth in this Subtopic, based on conditions as of the date of the modification of the lease. After the recording of the amounts called for by Subtopic 805-20, the leases shall be accounted for in accordance with this Subtopic. Subtopic 840-30 explains the application of this paragraph to a leveraged lease by an entity that acquires a lessor. This Subtopic does not address the subsequent accounting for amounts recorded for favorable or unfavorable operating leases.

The classification of a lease in accordance with the criteria of ASC 840-10-25 is not to be changed as a result of a business combination unless the provisions of the lease agreement are modified such that they give rise to a new agreement under ASC 840-10-35-4 (see Section 3.4).

According to ASC 840-10-35-4, once the classification of a lease is determined, that classification is not changed unless:

1. Both parties to the lease agree to a revision that would have resulted in a different classification had the changed terms been in effect at the inception of the lease

Or

2. The lease is extended or renewed beyond the existing lease term

The provisions of ASC 840-10-25-27 and ASC 840-10-35-5 apply to both lessees and lessors in a business combination.

Although the classification of a lease does not change unless it is modified as part of the business combination, the principles governing the recognition of assets and liabilities in a business combination apply to acquired lease arrangements. In addition, intangible assets or liabilities related to in-place leases may be recognized as part of a business combination. Assets and liabilities related to lease arrangements are recognized at fair value. The fair value measurement framework in ASC 820, *Fair Value Measurement*, should be used to determine fair value of lease related assets acquired and liabilities assumed in business combinations accounted for under ASC 805, *Business Combinations*. The following sections provide further discussion on the accounting for lease related assets and liabilities that are recognized as part of a business combination. See our Business combinations FRD for further discussion on accounting for business combinations.

The provisions for accounting for leases in a business combination do not apply to the acquisition of a lease or a portfolio of leases that is not the result of a business combination. The accounting for a lease in an asset acquisition is discussed in Section 13.4 (lessor) and Section 13.5 (lessee).

13.1 Changes in the provisions of the lease

If the provisions of the lease are modified in connection with a business combination in a way that would require the revised lease to be considered a new agreement under ASC 840-10-35-4 (see Sections 3.4), the lease should be classified based on conditions as of the modification of the lease. For example, if at the date of an acquisition, an operating lease of the acquired company was modified such that the lease would have been classified as a capital lease at inception had the modified terms been in effect, the lease would be treated as a new lease by the combined entity. Accordingly, the classification tests would be made as of the combination date (see Sections 4.2, 4.3.7 – 4.3.8 and Section 5.1.4 for discussion of lease revisions).

If the only change in a lease as a result of the business combination consists of changing the identity of the parties because of a business combination, this modification would not represent a new agreement between the lessee and lessor and classification of the lease is not changed.

13.2 Business combination – no changes in the provisions of a lease

The classification of a lease is required to be determined at its inception. Thus, an acquisition does not result in the reconsideration of the original classification determination. In paragraph 7 of FIN 21, the FASB said that it does not believe that a business combination requires reconsideration, at the time of purchase, of the classification of existing leases that are already classified in conformity with lease classification criteria (i.e., ASC 840-10-25). ASC 805 only requires the valuation of the existing assets and obligations of the acquired company, including assets and obligations pertaining to leases. Subsequent to the recording of any adjustments required by the application of acquisition accounting, the leases would be accounted for in accordance with ASC 840.

Lessee

Operating lease – A business combination that includes an operating lease commitment requires an assessment of whether the operating lease terms are favorable or unfavorable given market conditions that exist at the date of the acquisition. To the extent the lease arrangement is favorable or unfavorable relative to market on the acquisition date or has an inherent value (i.e., value of an in-place lease), an asset or liability is recognized at fair value in the business combination. The estimate of fair value should consider all provisions of the lease (term, purchase options, renewal options, termination penalties, residual value guarantees, etc.) from the perspective of a market participant and should be calculated pursuant to the provisions of ASC 820 (see our Fair value measurements and disclosures FRD for further discussion).

Generally, the recognized asset or liability is amortized to rental expense over the term of the lease so that level rent expense (absent provisions that could result in fluctuating rent expense, such as contingent rent provisions), that conceptually should represent market rental cost per period based on market conditions at the acquisition date, is recognized each period over the remainder of the lease term. However, if a portion of the fair value relates to a lease purchase option, we believe the value attributed to the lease purchase option, provided it is likely it will be exercised, would not be amortized over the term of the lease, but rather would affect the recognized value of the asset upon exercise of the purchase option. For example, if the acquired purchase option on the leased asset is in-the-money on the acquisition date, the accounting basis of the subject asset upon exercise of the purchase option would be the sum of the exercise price plus the fair value of the acquired purchase option on the acquisition date. Additionally, if a portion of the fair value relates to a renewal option that was not included in the original lease term (see Section 2.6), provided it is determined that it is likely the option will be exercised (e.g., because of favorable market conditions), the value attributed to the renewal would not be amortized over the term of the lease, but rather would be amortized over the renewal period. Furthermore, the fair value of any leasehold improvements would be recognized the same as other plant and equipment assets acquired.

In addition, an acquirer would not recognize any deferred rent previously recognized by the acquired entity because the lease is recognized at its acquisition-date fair value and the acquiree's deferred rent does not meet the definition of an asset or liability at the acquisition date.

Capital lease – A business combination that includes an asset under a capital lease and a capital lease obligation requires both the asset and obligation to be recorded at fair value as of the date of the acquisition. The fair value of the capital lease obligation should be measured similar to assumed debt. That is, the adjustment to record the lease obligation at fair value would be based on an adjustment of the implicit rate in the lease (see Section 2.10) to the acquirer's market rate under a similar financing at the time of the acquisition. The fair value of assets under a capital lease should be measured and recognized similar to other acquired assets and should be considered independent of the fair value of the lease contract (i.e., the inherent and off-market fair value of the lease). We do not expect that a separate intangible asset or liability will be recognized for the inherent or off-market fair value of a capital lease arrangement; rather, those values would be reflected in the measurement of the assets under capital lease and the capital lease obligation.

In measuring the amount to recognize for an acquired asset under capital lease, the acquirer should consider why the lease was originally classified as a capital lease (see Section 3.2). That is, if the acquired lease was capitalized by the acquiree because the lease met one of the first two criteria set forth in ASC 840-10-25-1 (i.e., (a) title transfers to the acquiree or (b) the lease contains a bargain purchase option at the end of the lease term), the asset is recognized and measured by the acquirer at its acquisition-date fair value of the underlying asset. If it is not anticipated that the acquirer will obtain ownership of the leased asset (meaning the acquired leased asset was capitalized because (c) the lease term is equal to 75% or more of the estimated economic life of the leased property or (d) the present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property) or the acquirer does not intend to exercise any in-place bargain purchase option, the asset underlying the lease would be recognized and measured by the acquirer at the fair value of the leasehold interest (i.e., the value of the right to use the property for the remaining lease term and other rights under the lease). Any related leasehold improvements of the acquired entity would be recognized as tangible assets on the acquisition date at their fair value.

The fair value of the assets under capital lease and capital lease obligations should be determined accordance with ASC 820 (see our Fair value measurements and disclosures FRD for further discussion).

Illustration 13-1: Accounting for a capital lease acquired in a business combination

Assume an acquired company has a plant that it has leased since 20X0 and which it capitalized in accordance with the provisions of ASC 840-10-25. Also, assume the fair value of the asset and interest rates have increased since 20X0. When the acquisition occurred in 20X9, the applicable amounts were:

	Lessee book value	Acquisition date fair value
Capital lease asset	\$ 9,000,000	\$ 11,000,000
Capital lease obligation	\$ 10,000,000	\$ 8,000,000

In consolidation, the capital lease asset and obligation would be stated at \$11,000,000 and \$8,000,000, respectively. The subsequent accounting would be consistent with the requirements of ASC 840-30-35; that is, the asset would be amortized over the remaining term of the lease (or the useful life of the asset – if a purchase option exists) and the obligation would be reduced (using the interest method) using the acquirer's effective rate at the date of acquisition.

Lessor

Operating lease – In a business combination that includes assets subject to operating leases, in addition to recognizing the assets subject to a lease at fair value, an assessment is required to determine whether the underlying operating lease has an in-place value, as well as provisions that are off-market, favorable or unfavorable, given market conditions that existed on the date of the acquisition and the terms and conditions of the existing lease. The estimate of fair value should consider all provisions of the lease (term, purchase options, renewal options, termination penalties, residual value guarantees, etc.) and should be calculated pursuant to the provisions of ASC 820 (see our Fair value measurements and disclosures FRD for further discussion). The fair value of the assets subject to a lease and any asset or liability related to the lease contract are recognized and measured separately. To the extent the lease is favorable or unfavorable, an asset or liability is recognized as part of the business combination, in addition to any “in-place” value.

The asset or liability is generally amortized to rental income over the term of the lease so that level rental income is recorded over the lease term (see Section 2.6). However, if a portion of the fair value adjustment relates to a renewal option that was not included in the original lease term (e.g., a renewal option that is a bargain for the lessee as of the acquisition date) and it is determined that it is likely the option will be exercised, we believe the value attributed to the renewal would not be amortized over the term of the lease, but rather would be amortized over the renewal period.

An acquiring entity also may recognize a customer relationship intangible asset for its contractual relationship with any lessees.

Sales-type or direct finance lease – A business combination that includes the acquisition of a sales-type or direct finance lease receivable requires the receivable to be recorded at fair value as of the date of the acquisition. The adjustment to record the receivable at fair value would be based on an adjustment of the implicit rate in the lease (see Section 2.10) to market, as well as any increase in residual value based on market information at the time of the acquisition (it is assumed that downward adjustments of residual value and loan loss reserves were reflected previously by the acquired company). The fair value of the sales-type or finance lease receivable should be determined in accordance with ASC 820 (see our Fair value measurements and disclosures FRD for further discussion).

13.2.1 Considerations for valuing in-place leases

When real estate or other assets are acquired with in-place leases, the leases should be recorded at fair value. Further, some contracts, such as leases, may have value for reasons other than terms that are favorable relative to market prices.

In valuing in-place leases, various methods may be used to determine the fair value of the lease. These include the income method, the cost method and the market method. However, when valuing in-place leases, the following components should be considered in the valuation.

- ▶ **The fair value measurement framework in ASC 820** – See our Fair value measurements and disclosures FRD for further discussion on applying the provisions of ASC 820.
- ▶ **Above and below market rentals, as compared to current market rates for comparable leases** – Above market leases represent an asset to the acquirer, while below market payments may result in the assumption of a liability by the acquirer.
- ▶ **Direct costs associated with obtaining a new tenant** – The value of an in-place lease would include the direct costs that are avoided by acquiring the lease instead of originating the lease. These would include commissions, tenant improvements and other direct costs associated with obtaining a new tenant.
- ▶ **Opportunity costs associated with lost rentals** – In general, obtaining a new tenant will take some period of time, and during that period of time the real estate owner may not be receiving lease payments. This period, often referred to as the absorption period, represents an opportunity cost to the owner that is avoided if the real estate is acquired with an in-place lease.
- ▶ **Additional customer relationship intangible assets** – Consideration should be given as to whether the lease arrangements create a customer relationship asset under ASC 805. Examples of customer relationship assets might include the value, as a result of a current lease arrangement, associated with the expected renewal of the lease or the increased likelihood of obtaining the tenant as a tenant for other locations owned by the lessor.

In-place leases acquired with real estate would also meet the recognition criteria under ASC 805, and therefore must be recognized apart from the acquired real estate. As the useful life of an in-place lease is normally shorter than the remaining life of the building, separate recognition and amortization will affect the net earnings of the acquiring entity.

13.3 Leveraged lease

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Recognition

840-30-25-10

In a business combination or an acquisition by a not-for-profit entity, the acquiring entity shall retain the classification of the acquired entity's investment as a lessor in a leveraged lease at the date of the combination. The net investment of the acquired leveraged lease shall be broken down into its component parts, namely, net rentals receivable, estimated residual value, and unearned income including discount to adjust other components to present value.

Initial Measurement**840-30-30-15**

In a business combination or acquisition by a not-for-profit entity, the acquiring entity shall assign an amount to the acquired net investment in the leveraged lease in accordance with the general guidance in Topic 805, based on the remaining future cash flows and giving appropriate recognition to the estimated future tax effects of those cash flows.

Subsequent Measurement**840-30-35-32**

In a business combination or acquisition by a not-for-profit entity, the acquiring entity shall subsequently account for its acquired investment as a lessor in a leveraged lease in accordance with the guidance in this Subtopic as for any other leveraged lease. Example 5 (see paragraph 840-30-55-50) illustrates an acquiring entity's accounting for its acquired investment as a lessor in a leveraged lease.

If the acquiree in a business combination was a lessor in a leveraged lease, the general guidelines of ASC 805 also must be applied in assigning amounts to the net investment in the leveraged lease. The acquirer must determine the remaining net future cash flows and give appropriate recognition to the estimated future tax effects of such cash flows. Once this amount is determined, the net investment is then broken down into its component parts (net rentals receivable, estimated residual value and unearned income including the discount to adjust the other components to present value). Each component is then allocated a purchase price adjustment. Subsequent to the acquisition, the investment in the leveraged lease is accounted for by the acquirer in accordance with ASC 840-30 (see Section 14 for further discussion on accounting for leveraged leases).

A detailed illustration of the accounting for a leveraged lease in a business combination follows:

Excerpt from Accounting Standards Codification**Leases – Capital Leases****Implementation Guidance and Illustrations****840-30-55-50**

This Example illustrates one way that a lessor's investment in a leveraged lease might be valued by the acquiring entity in a business combination or an acquisition by a not-for-profit entity and the subsequent accounting for the investment in accordance with the guidance in this Subtopic. The elements of accounting and reporting illustrated for this Example are as follows:

- a. Acquiring entity's cash flow analysis by years (see paragraph 840-30-55-52)
- b. Acquiring entity's valuation of investment in the leveraged lease (see paragraph 840-30-55-53)
- c. Acquiring entity's allocation of annual cash flow to investment and income (see paragraph 840-30-55-54)
- d. Journal entry for recording allocation of purchase price to net investment in the leveraged lease (see paragraph 840-30-55-55)
- e. Journal entries for the year ending December 31, 1984 (Year 10 of the lease) (see paragraph 840-30-55-56).

840-30-55-51

This Example has the following 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

Financing:

Equity investment by lessor	\$400,000
Long-term non-recourse 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 asset depreciation range 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
Date of business combination	January 1, 1982
Tax status of business combination	Non-taxable transaction
Appropriate interest rate for valuing net-of-tax return on investment	4 1/2%

840-30-55-52

Acquiring entity's cash flow analysis by years follows.

Year	(1) Gross lease rentals and residual value	(2) Depreciation (for income tax purposes)	(3) Loan interest payments	(4) Taxable income (col. 1-2-3)	(5) Income tax (charges) (col. 4 x 50.4%)	(6) Loan principal payments	(7) Annual cash flow (col. 1-3+5-6)
8	\$ 90,000	\$ -	\$ 37,079	\$ 52,921	\$ (26,672)	\$ 37,357	\$ (11,108)
9	90,000	-	33,717	56,283	(28,367)	40,719	(12,803)
10	90,000	-	30,052	59,948	(30,214)	44,383	(14,649)
11	90,000	-	26,058	63,942	(32,227)	48,378	(16,663)
12	90,000	-	21,704	68,296	(34,421)	52,732	(18,857)
13	90,000	-	16,957	73,043	(36,813)	57,478	(21,248)
14	90,000	-	11,785	78,215	(39,420)	62,651	(23,856)
15	90,000	-	6,145	83,855	(42,263)	68,290	(26,698)
16	200,000	100,000	-	100,000	(50,400)	-	149,600
Total	\$ 920,000	\$ 100,000	\$183,497	\$636,503	\$ (320,797)	\$411,988	\$ 3,718

840-30-55-53

Acquiring entity's valuation of investment in the leveraged lease follows.

Cash flow	Present value at 4-1/2% net-of- tax rate
1. Rentals receivable (net of principal and interest on the non-recourse debt) (\$15,564.70 at the end of each year for 8 years)	\$ 102,663
2. Estimated residual value (\$200,000 realizable at the end of 9 years)	134,581
3. Future tax payments (various amounts payable over 9 years – see the table in the preceding paragraph)	<u>(253,489)</u>
Net present value	<u>\$ (16,245)</u>

840-30-55-54

Acquiring entity's allocation of annual cash flow to investment and income follows (see footnote [a]).

Year	(1)	(2)	Annual cash flow		Components of income ^b	
	Net investment at beginning of year	Total from col. 7 of the table in para. 840-3-55-52	Allocated to investment	Allocated to income ^a	Pretax income	Tax effect of pretax income
8	\$ (16,245)	\$ (11,108)	\$ (11,108)	\$ –	\$ –	\$ –
9	(5,137)	(12,803)	(12,803)	–	–	–
10	7,666	(14,649)	(14,973)	324	5,530	(5,206)
11	22,639	(16,663)	(17,621)	958	16,353	(15,395)
12	40,260	(18,857)	(20,561)	1,704	29,087	(27,383)
13	60,821	(21,248)	(23,822)	2,574	43,937	(41,363)
14	84,643	(23,856)	(27,439)	3,583	61,160	(57,577)
15	112,082	(26,698)	(31,443)	4,745	80,995	(76,250)
16	143,525	149,600	143,525	6,075	103,698	(97,623)
Totals		<u>\$ 3,718</u>	<u>\$ (16,245)</u>	<u>\$ 19,963</u>	<u>\$ 340,760</u>	<u>\$ (320,797)</u>

a Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which, if 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.

b Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4. Journal Entry 2 in paragraph 840-30-55-56 includes an example of this computation.

840-30-55-55

Illustrative journal entry for recording allocation of purchase price to net investment in the leveraged lease follows.

Rentals receivable (table in paragraph 840-30-55-52, total of column 1 minus residual value, minus totals of columns 3 and 6)	\$ 124,515
Estimated residual value (paragraph 840-30-55-51)	200,000
Purchase price allocation clearing account (paragraph 840-30-55-53, present value)	16,245
Unearned and deferred income (paragraph 840-30-55-53, present value, minus total of rentals receivable and estimated residual value)	<u>\$ 340,760</u>

840-30-55-56

Illustrative journal entries for year ending December 31, 1984 follows.

Third year of operation after the business combination (Year 10 of the lease)**Journal Entry 1**

Cash	\$ 15,565	
Rentals receivable (table in paragraph 840-30-55-52, column 1 minus columns 3 and 6)		\$ 15,565
<i>Collection of year's net rental</i>		

Journal Entry 2

Unearned and deferred income	\$ 5,530	
Income from leveraged leases (table in paragraph 840-30-55-54, column 5)		\$ 5,530
<i>Recognition of pretax income for the year allocated in the same proportion as the allocation of total income, [computed as follows: ($\\$324 \div \\$19,963 \times \\$340,760 = \\$5,530$)]</i>		

Journal Entry 3

Deferred taxes (table in paragraph 840-30-55-52, column 5, minus table in paragraph 840-30-55-54, column 6)	\$ 25,008	
Income tax expense (table in paragraph 840-30-55-54, column 6)	5,206	
Cash (table in paragraph 840-30-55-52, column 5)		\$ 30,214
<i>To record payment of tax for the year</i>		

13.4**Asset acquisition – lessor**

Assessing whether a purchase of a lease portfolio is a business combination (possibly resulting in goodwill) or an asset acquisition where the consideration paid is ascribed entirely to the acquired assets is based on the guidance in ASC 805. In an asset acquisition, the guidance in ASC 350-30-25 should be followed. Further discussion on determining whether an acquisition of an asset or a group of assets should be accounted for as an asset acquisition or a business combination is included in our Business combinations FRD. Discussion of accounting for an asset acquisition is also included in our Business combinations FRD.

13.4.1**Accounting for book and tax basis differences on the purchase of a lease portfolio**

The tax effect of asset purchases (e.g., certain acquisitions of leases) that are not business combinations in which the amount paid differs from the tax basis of the asset should not result in immediate income statement recognition. The simultaneous equations method should be used to record the assigned value of the asset and the related deferred tax asset or liability at the date of the acquisition (ASC 740-10-25-51).

Illustration 13-2: Accounting for book-tax basis differences in an asset acquisition

Assume that a company pays \$2,000,000 for a portfolio of finance lease receivables in a nontaxable acquisition (that is, carryover basis of \$1,000,000 for tax purposes). Because the transaction represents the acquisition of a portfolio, no goodwill is recognized for financial accounting purposes. A deferred tax liability would need to be recorded for the temporary difference (in this case, the entire \$2,000,000 less the tax basis \$1,000,000 plus the tax-on-tax effect from increasing the carrying amount of the lease receivables acquired). The tax rate is 35%.

The amounts assigned to the lease receivables and the related deferred tax liability should be determined using the simultaneous equations method as follows (where FBB is final book basis; CPP is cash purchase price; and DTL is deferred tax liability):

Equation A (determine the FBB of the lease receivable):

$$\text{FBB} - (\text{Tax rate} \times (\text{FBB} - \text{Tax basis})) = \text{CPP}$$

Equation B (determine the amount assigned to the DTL):

$$(\text{FBB} - \text{Tax basis}) \times \text{Tax rate} = \text{DTL}$$

In the above example, the following variables are known:

Tax basis	\$ 1,000,000
Tax rate	35%
CPP	\$ 2,000,000

The unknown variables (FBB and DTL) are solved as follows:

Equation A: FBB	\$ 2,538,462
Equation B: DTL	\$ 538,462

Accordingly, the company would record the following journal entry:

Lease receivable	\$ 2,538,462	
DTL		\$ 538,462
Cash		2,000,000

13.5 Asset acquisition – lessee

Consistent with the accounting by a new lessee in a sublease (see Section 12.4), a new lessee as a consequence of an asset acquisition must reassess the assumed lease and classify the lease as a capital or operating lease in accordance with ASC 840-10-25-1 (see Section 3.2) (i.e., as a capital or operating lease). That is, a lessee that acquires an interest in a lease (lessee) in an asset acquisition does not automatically retain the prior lease classifications as generally is the case in a business combination.

13.6 Lease of property from a third party entered into as part of a business combination

In certain business combinations, a third party unrelated to the acquiree or acquirer is inserted into the transaction to acquire certain assets of the business directly from the acquiree that will in turn be leased by the third party to the acquirer of the business. The question has arisen as to whether such transactions should be accounted for as the acquisition, sale and leaseback of the assets or simply as a lease transaction by the acquirer. In our view, although the transaction may in form be a lease of assets, it is in substance a sale-leaseback and should be accounted for as such if the assets to be leased are acquired by the third party in contemplation of, or contingent upon, the acquisition of a business by the acquirer-lessee.

14 Leveraged leases

14.1 Definition of a leveraged lease

Excerpt from Accounting Standards Codification

Leases – Overall

Recognition

840-10-25-33

From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as nonleveraged leases.

840-10-25-43

If the lease at inception meets any of the four lease classification criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph, it shall be classified by the lessor as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as follows:

- a. Sales-type lease. A lease is a sales-type lease if it gives rise to manufacturer's or dealer's profit (or loss) to the lessor (that is, the fair value of the leased property at lease inception is greater or less than its cost or carrying amount, if different) and meets either of the following conditions:
 1. It involves real estate and meets the criterion in paragraph 840-10-25-1(a) (in which circumstance, neither of the criteria in paragraph 840-10-25-42 applies).
 2. It does not involve real estate and meets any of the criteria in paragraph 840-10-25-1 and both of the criteria in paragraph 840-10-25-42.

For implementation guidance on the interaction of lease classification and lessor activities, see paragraph 840-10-55-41.

- b. Direct financing lease. A lease is a direct financing lease if it meets all of the following conditions:
 1. It meets any of the criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph.
 2. It does not give rise to manufacturer's or dealer's profit (or loss) to the lessor.
 3. It does not meet the criteria for a leveraged lease in (c).
- c. Leveraged lease. Leases that meet the criteria of sales-type leases set forth in (a) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph 840-30-25-6. A lease is a leveraged lease if it has all of the following characteristics:
 1. It meets the criteria in (b)(1) and (b)(2) for a direct financing lease.
 2. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
 3. 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.

4. The lessor's net investment (see paragraph 840-30-25-8) 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.
- d. Operating lease. A lease is an operating lease if it does not meet any of the four criteria in paragraph 840-10-25-1 or both of the criteria in the preceding paragraph. This includes a lease that involves real estate and gives rise to manufacturer's or dealer's profit (or loss) to the lessor but that does not meet the criterion in paragraph 840-10-25-1(a).

Leases – Capital Leases

Recognition

840-30-25-8

The lessor shall record its investment in a leveraged lease. The net of the balances of the following accounts as measured in accordance with this Subtopic shall represent the lessor's initial and continuing investment in leveraged leases:

- a. Rentals receivable
- b. Investment-tax-credit receivable
- c. Estimated residual value of the leased asset
- d. Unearned and deferred income.

840-30-25-9

If the projected net cash receipts (that is, gross cash receipts minus gross cash disbursements exclusive of the lessor's initial investment) over the term of the leveraged lease are less than the lessor's initial investment, the deficiency shall be recognized by the lessor as a loss at lease inception.

A lease is a leveraged lease if it has all of the following characteristics, at the inception of the lease (see Section 2.2):

- ▶ It meets the criteria for a direct financing lease.
- ▶ It involves at least three parties: a lessee, a long-term creditor and a lessor (commonly referred to as the equity participant).
- ▶ The financing provided by the long-term creditor is non-recourse as to the general credit of the lessor. The amount of the financing is sufficient to provide the lessor with "substantial leverage" in the transaction. ASC 840 does not provide specific guidance on what is "substantial leverage" but the illustration of leveraged lease accounting in ASC 840-30-55 assumes 60% non-recourse financing by the third-party lenders and 40% investment by the equity participant (lessor).
- ▶ The lessor's net investment declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination.

If all of these characteristics exist, the lease would be accounted for by the lessor as a leveraged lease. All other leases should be accounted for as sales-type, direct financing or operating leases by the lessor, as appropriate. Leveraged lease treatment is not relevant to the lessee. Often the lessor purchases residual value insurance to achieve finance lease treatment while the lessee has an operating lease (see Section 2.9.3).

Special accounting rules are provided for leveraged leases using the “investment with separate phases method” (see Section 14.2.2) because of the unique combination of characteristics of such leases that produces an overall economic effect that is distinct from that of other transactions.

In a typical leveraged lease, lessee rental payments may be equal to or exceed the non-recourse debt service payments in all periods. Those typical leveraged lease transactions generate depreciation deductions for income tax purposes that exceed the net of rental income and interest expense and result in tax savings to lessors during the early periods of the lease term. Those tax savings allow the lessor to recover its equity investment quickly, leaving excess cash in the middle periods but requiring reinvestment of cash in the later periods to pay deferred taxes as they become due.

14.2

Accounting for leveraged leases

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Initial Measurement

840-30-30-14

The lessor shall initially measure its investment in a leveraged lease net of the nonrecourse debt (as discussed in paragraph 840-30-25-8). 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 lease inception except as provided in paragraph 840-30-30-7.
- d. Unearned and deferred income consisting of both of the following:
 1. The estimated pretax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income over the lease term
 2. The investment tax credit remaining to be allocated to income over the lease term.

Subsequent Measurement

840-30-35-33

The investment in leveraged leases minus 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 leveraged lease. 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 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 and is distinct from the interest rate implicit in the lease. In each year, whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The use of the term years is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods.

840-30-35-34

The net income a lessor recognizes on a leveraged lease shall be composed of the following three elements:

- a. Pretax lease income (or loss)
- b. Investment tax credit
- c. Tax effect of pretax lease income (or loss).

840-30-35-35

The pretax lease income (or loss) and investment tax credit elements shall be allocated in proportionate amounts from the unearned and deferred income included in the lessor's net investment (as described in paragraph 840-30-30-14[d]). The tax effect of the pretax lease income (or loss) recognized 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. Example 2 (see paragraph 840-30-55-29) illustrates this guidance.

840-30-35-36

If at any time during the lease term the application of the method prescribed in this Subtopic would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in circumstances in which one of the important assumptions affecting net income is revised (see paragraphs 840-30-35-38 through 35-47).

14.2.1**Determining the leveraged lease investment**

The net investment reflected in the lessor's balance sheet, which increases or decreases by the amount of the difference between each period's net cash flow and the income recognized, consists of:

- ▶ Rentals receivable, net of the portion applicable to principal and interest on the related non-recourse debt.
- ▶ A receivable for the investment tax credit until it is realized (the investment tax credit was repealed by the Tax Reform Act of 1986).
- ▶ The estimated residual value of the leased asset (see Section 2.8).
- ▶ Unearned income (the remaining amount of estimated pretax lease income or loss and investment tax credit to be allocated to income over the lease term, after deducting initial direct costs – see Section 2.12).

The accounting for deferred taxes in a leveraged lease is specifically excluded from the general accounting for income taxes in ASC 740, *Income Taxes*, and computed in accordance with guidance provided in ASC 840 (specifically ASC 840-30-30-14 and ASC 840-30-35-33 through 35-35). Although deferred taxes are included in the net investment in the leveraged lease for purposes of computing income (see Section 14.2.2), deferred taxes relating to leveraged leases are shown on the balance sheet with other deferred tax items (i.e., deferred taxes computed in accordance with ASC 740) and not netted against the lease investment.

14.2.2 Recording income on a leveraged lease

The “investment with separate phases method,” which is required to be used to account for leveraged leases, recognizes lease income at a level rate of return on the net investment in those periods in which the net investment at the beginning of the period is a positive amount. This method and the FASB’s rationale for requiring its use are described in the basis for conclusions for Statement 13 (paragraph 109(c) of Statement 13). Typically, the net investment in a leveraged lease follows this pattern:

Early periods	Positive, based on initial investment in leased property
Middle periods	Negative, due mainly to large income tax deductions from accelerated depreciation and high interest payments on the non-recourse debt
Later periods	Positive, as accelerated depreciation reverses and interest payments diminish
Final period	Zero, as residual value is realized on sale of the property

When the FASB originally deliberated Statement 13, it rejected the theory of accruing so-called “secondary earnings” (earnings on temporary funds to be reinvested) over the lease term. Instead, in its basis for conclusions, the FASB stated these earnings should be recorded in income only when they occur because this is the economic reality of the transaction and because anticipation of future interest on funds expected to be held temporarily has no support in present generally accepted accounting principles (paragraph 109(d) of Statement 13).

The determination of the net investment and the amount of income recognized are interdependent. Income is recognized using a rate calculated by a trial and error process which is repeated until a rate is selected which develops a total amount allocated to income that is equal to the net cash flow. As a practical matter, a computer program normally would be used to calculate this rate.

Income from a leveraged lease is segregated into three components: pretax lease income, tax effect of the pretax lease income and investment tax credit. The amount of each component to be recognized each accounting period is based on the ratio of the after-tax net income for the period (as computed based on a Multiple Investment Sinking Fund – MISF yield) to the total after tax net income from the lease times the total pretax lease income, total tax effect and total investment tax credit. A loss would be recognized immediately for any projected excess of gross cash disbursements, excluding the initial investment, over the gross cash receipts from a leveraged lease.

See Section 2.13.3 for discussion of lessor accounting for contingent rent.

14.2.3 Accounting for income taxes related to leveraged leases

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Other Presentation Matters

840-30-45-5

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.

840-30-45-6

Integration of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes under Topic 740 is required if deferred tax credits related to leveraged leases are the only source (see paragraph 740-10-30-18) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined in accordance with this Subtopic differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the guidance in Topic 740, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards.

840-30-45-7

This Subtopic requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination or an acquisition by a not-for-profit entity shall not be accounted for as a deferred tax credit. Any tax effects included in unearned and deferred income as required by this Subtopic shall not be offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a combination shall be accounted for in the same manner as for leveraged leases that were not acquired in a combination.

Implementation Guidance and Illustrations**840-30-55-17**

The accounting for income taxes related to leveraged leases set forth in this Subtopic is not consistent with the guidance in Topic 740.

840-30-55-18

The integration of the results of accounting for income taxes related to leveraged leases with the other results of accounting for income taxes as required by Topic 740 is an issue if all of the following exist:

- a. The accounting for a leveraged lease requires recognition of deferred tax credits.
- b. The guidance in Topic 740 limit the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.
- c. Unrecognized tax benefits in this paragraph could offset taxable amounts that result from future recovery of the net investment in the leveraged lease.

Example 3 (see paragraph 840-30-55-39) illustrates the application of this guidance.

Deferred income taxes in leveraged lease transactions are accounted for under specific guidance provided in ASC 840 and not the general guidance related to accounting for income taxes provided in ASC 740, *Income Taxes*. Income tax rates are an important assumption in determining the rate of return on a leveraged lease. If tax rates change, lessors must recalculate the allocation of income on the leveraged lease if the rate changes have an impact on the after-tax cash flows from the lease (see Section 14.2.4). In addition, ASC 840-30-30-15 (see Section 13.3) provides specific guidance for allocated consideration in a business combination to acquired leveraged leases (see Section 13.3 for further discussion). Although the accounting for income taxes related to leveraged leases in ASC 840 is not consistent with the general guidance related to accounting for income taxes in ASC 740, as indicated

in the basis for conclusions for Statement 109, when deliberating the general guidance related to accounting for income taxes the FASB decided not to re-open the subject of leveraged lease accounting (paragraph 126 of Statement 109).

Integration of leveraged lease income tax accounting and accounting for other temporary differences is required when deferred tax credits related to leveraged leases are the only source of taxable income when assessing the need for a valuation allowance for deferred tax assets not related to leveraged leases. A valuation allowance is not required when the deductible temporary differences and carryforwards will offset taxable amounts from the future recovery of the net investment in the leveraged lease. However, to the extent the amount of leveraged-lease deferred tax credits as determined in accordance with the methods prescribed by the leveraged lease guidance found in ASC 840 differs from the amount of the deferred tax liability that would result from applying the general guidance for income taxes in ASC 740, that difference is preserved and is not considered a source of taxable income for purposes of recognizing the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards. In other words, the taxable temporary difference that would result from applying the general guidance for deferred income taxes in ASC 740 is all that can be considered in evaluating the need for a valuation allowance.

The following illustration, although somewhat simplified, depicts the requirement to preserve the difference between deferred tax balances that result from applying the special guidance for accounting for deferred income taxes in ASC 840 applicable to leveraged leases and those that would result from applying the general provisions for accounting for income taxes in ASC 740.

Illustration 14-1: Integration of leverage lease income tax accounting and accounting for other temporary differences

Assume that a company entered a leveraged lease when tax rates were 45%, and tax rates are subsequently reduced to 35% (at the end of year two). At the end of year two, deferred tax effects related to the leveraged lease are computed as follows:

	<u>ASC 840</u>	<u>ASC 740</u>
Net rentals receivable	\$ 2,000	\$ 2,000
Tax basis	<u>(1,500)</u>	<u>(1,500)</u>
Taxable temporary difference	500	500
Tax rate	<u>40%¹</u>	<u>35%</u>
Deferred tax liability	<u>\$ 200</u>	<u>\$ 175</u>

Also assume at the end of year 2 the company has a deductible temporary difference of \$1,500 scheduled to reverse in year 6 arising from a warranty accrual. Absent consideration of the deferred tax credits related to the leveraged lease, the weight of available evidence indicates that a valuation allowance is required for the entire \$525 deferred tax asset (\$1,500 x 35%). In this case, a valuation allowance would be required for \$350 (\$525-\$175) and a net deferred tax benefit of \$175 is recognized. Although the recorded deferred tax credit is \$200, \$25 of that credit relates to special tax recognition provisions related to leveraged lease transactions and that difference should be preserved and is not available for offsetting.

¹ Derived. Deferred tax effects computed under ASC 840, adjusting for the change in total net income from the lease as a result of the decrease in tax rates from 45% to 35%.

14.2.4 Change in leveraged lease assumptions

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Subsequent Measurement

840-30-35-38

Any estimated residual value and all other important assumptions affecting estimated total net income from the leveraged lease shall be reviewed at least annually. The rate of return and the allocation of income to positive investment years shall be recalculated from lease inception following the method described in paragraphs 840-30-35-33 through 35-35 and using the revised assumption if, during the lease term, any of the following conditions occur:

- 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.
- c. The projected timing of the income tax cash flows is revised.

840-30-35-39

The lessor shall update all assumptions used to calculate total and periodic income if the lessor is performing a recalculation of the leveraged lease. That recalculation shall include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation.

840-30-35-40

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 gain or loss shall be recognized as follows:

- a. The pretax gain or loss shall be included in income from continuing operations before income taxes in the same line item in which leveraged lease income is recognized.
- b. The tax effect of the gain or loss shall be included in the income tax line item.
- c. An upward adjustment of the estimated residual value (including any guaranteed portion) shall not be made.

Example 2 (see paragraph 840-30-55-29) illustrates the accounting guidance in this paragraph.

840-30-35-41

The projected timing of income tax cash flows generated by the leveraged 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. The income effect of a change in the income tax rate shall be recognized in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law.

840-30-35-42

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 or projected timing of the tax benefits generated by a leveraged lease as a result of any of the following circumstances would require a recalculation because that change in timing is directly related to that lease:

- 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
- c. A change in the lessor's expectations about settlement with the taxing authority.

840-30-35-43

In contrast, as discussed in paragraph 840-30-35-52, 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. A recalculation would not be required unless there is an indication that the previous assumptions about total after-tax net income from the leveraged lease were no longer valid.

840-30-35-44

Tax positions shall be reflected in the lessor's initial calculation or subsequent recalculation based on the recognition, derecognition, and measurement criteria in paragraphs 740-10-25-6, 740-10-30-7, and 740-10-40-2. The determination of when a tax position no longer meets those criteria is a matter of individual facts and circumstances evaluated in light of all available evidence.

840-30-35-45

If the lessor expects to enter into a settlement of a tax position relating to a leveraged lease 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.

840-30-35-46

The recalculation of income from the leveraged lease shall not include interest or penalties in the cash flows from the leveraged lease.

840-30-35-47

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.

When important assumptions are changed that affect estimated total net income from the lease, including any permanent decline in the estimated residual value and the rate of return, the allocation of income to periods in which the net investment is positive is recomputed from the inception of the lease. The net investment is then adjusted to equal the recalculated balance and a gain or loss is recognized. Upward adjustments in estimated residual value are prohibited. Sections 14.2.4.1 through 14.2.4.6 provide an overview of common changes in assumptions impacting leveraged leases.

14.2.4.1 Impact of change in effective tax rate

The lessor's income tax rate is an important assumption in accounting for a leveraged lease. Accordingly, the income effect of a change in the income tax rate should be recognized in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law. If accounting for the effect on leveraged leases of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the reason for that variation should be disclosed (ASC 840-30-50-6 – see Section 14.3).

All components of a leveraged lease must be recalculated from inception of the lease based on the revised after-tax cash flows arising from the change in the tax law, including revised tax rates and repeal of the investment tax credit. The difference between the amounts originally recorded and the recalculated amount would be included as a cumulative catch-up in income of the period in which the tax law is enacted.

14.2.4.2 Impact of AMT on leveraged lease accounting

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Subsequent Measurement

840-30-35-48

An entity shall include assumptions about the effect of the alternative minimum tax, considering its consolidated tax position, in leveraged lease computations.

840-30-35-49

Any difference between alternative minimum tax depreciation and the tax depreciation assumed in the leveraged lease or between income recognition for financial reporting purposes and alternative minimum tax income could, depending on the lessor's overall tax situation, result in alternative minimum tax or the utilization of alternative minimum tax credits.

840-30-35-50

If alternative minimum tax is paid or an alternative minimum tax credit is utilized, the total cash flows from the leveraged lease could be changed, and the lessor's net investment in the leveraged lease and income recognition would be affected.

840-30-35-51

If a change to the tax assumptions changes total estimated after-tax net income, the rate of return on the leveraged lease should be recalculated from inception, the accounts constituting the lessor's net investment should be adjusted, and a gain or loss recognized in the year in which the assumption is changed.

840-30-35-52

However, an entity whose tax position frequently varies between alternative minimum tax and regular tax would not be required to recalculate the rate of return on the leveraged lease each year unless there was an indication that the original assumptions regarding total after-tax net income from the lease were no longer valid. In that circumstance, the entity would be required to revise the leveraged lease computations in any period in which total net income from the leveraged lease changes due to the effect of the alternative minimum tax on cash flows for the lease.

The lessor's income tax rate and the amount of taxes paid or tax benefits received are important assumptions in a leveraged lease calculation. Any difference between Alternative Minimum Tax ("AMT") depreciation and the tax depreciation assumed in the leveraged lease or between income recognition for financial reporting purposes and AMT income could, depending on the lessor's overall tax situation, result in AMT or the utilization of AMT credits. In the circumstances in which AMT is paid or an AMT credit is utilized, the total cash flows from the leveraged lease could be changed, and the lessor's net investment in the leveraged lease and income recognition would be affected.

An entity should include assumptions regarding the effect of the AMT, considering its consolidated tax position, in leveraged lease computations. An entity whose tax position frequently varies between AMT and regular tax would not be required to recompute each year, unless there was an indication that the original assumptions regarding total after-tax net income from the lease were no longer valid. In that circumstance, the entity would be required to revise the leveraged lease computations in any period in which management believes that total net income from the leveraged lease will be affected due to the effect of the AMT on cash flows for the lease.

14.2.4.3

Impact of change or projected change in the timing of cash flows relating to income taxes generated by a leveraged lease transaction

The timing of the cash flows relating to income taxes generated by a leveraged lease is an important assumption that affects the periodic income recognized by the lessor for that lease. Because tax benefits in a leveraged lease are often realized in the early periods of the lease, disproportionately more income from the lease is typically allocated to earlier periods. For certain leveraged lease transactions, the Internal Revenue Service (IRS) has challenged both the ability to accelerate the timing of tax deductions and the amounts of those deductions. The settlement in a challenge from the IRS may result in a significant change in the timing of the realization of tax benefits, which changes the timing of the estimated after-tax cash flows from the leveraged lease (and therefore the timing of income recognition from the lease) and reduces the overall expected rate of return, although it does not change the estimated total net income. The settlement may also result in interest and penalties that would change the estimated total net income from the lease.

Lessors are required to review the projected timing of income tax cash flows generated by a leveraged lease annually, or more frequently if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. If the projected timing of the income tax cash flows is revised, the rate of return and the allocation of income to positive investment years should be recalculated from the inception of the lease based on the revised projected cash flows, including any projected settlements and an update of all assumptions used. The recalculation should include the actual or expected changes and an update of all assumptions in timing of all cash flows, including those due to AMT credits or net operating loss carryforwards, if significant. The recalculation should not include interest or penalties in the cash flows from the leveraged lease. Any advance payments or deposits made with a taxing authority should not be considered an actual cash flow of the leveraged lease; rather, those payments and deposits should be included in the projected settlement amount. The difference between the amounts originally recorded and the recalculated amount should be recognized as a gain or loss in income from continuing operations in the year in which the assumption is changed in the same line item in which leveraged lease income is recognized. The tax effect of the recognized gain or loss should be included in the income tax line item (ASC 840-30-35-41 through 35-47 – see Section 14.2.4).

The following example illustrates how a lessor would include advance payments in a recalculation of a leveraged lease:

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Implementation Guidance and Illustrations

840-30-55-47

This Example illustrates how (in accordance with the guidance in paragraph 840-30-35-45 and others) a lessor would include advance payments and deposits in a recalculation of a leveraged lease resulting from a determination by the lessor that it would enter into a settlement of a tax position arising from a leveraged lease.

840-30-55-48

This 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 Subtopic 740-10. It also assumes that the lessor would conclude that the estimate of \$50 for the projected lease-in, lease-out settlement is consistent with the measurement guidance in that Subtopic.

840-30-55-49

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 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 (IRS) 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 lease-in, lease-out 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.

Tax positions should be reflected in a lessor's initial calculation and/or subsequent recalculation based on the recognition, derecognition and measurement criteria in ASC 740-10 (see our Accounting for income taxes FRD for further discussion).

14.2.4.4

Impact of a change in estimated residual value

As noted in ASC 840-30-35-40(c) (see Section 14.2.4) an upward adjustment of the estimated residual value is prohibited. Transactions in which a lessor has sold an interest in any appreciation in residual value to a third party investor have raised the question as to whether reflecting such a sale is essentially recognizing appreciation in the residual value. The following example illustrates.

Lessor X is the equity participant in a leveraged lease. When the leveraged lease was originally recorded, the residual value was determined to be \$100. A group of speculators now pay \$30 for an option for any excess of the residual value over \$100. Either the speculators would pay the \$100 to Lessor X at the end of the lease and sell the asset itself, or Lessor X would sell the asset and all proceeds in excess of \$100 would be paid to the speculators. The question concerns how to account for the \$30 when it is received. The following three alternatives have been identified:

1. Treat the \$30 cash inflow as a change in lease assumptions in accordance with ASC 840-30-35-38 through 35-40 (see Section 14.2.4) and recalculate the cash flows from the leveraged lease since inception by including the \$30 received in the current year with no change in the \$100 residual reflected at the end of the lease. Any income tax expense related to the \$30 option premium should also be reflected in the revised cash flow in the period in which it is subject to income tax. A cumulative catch-up adjustment would be recorded in the current year resulting from the difference between cumulative income to date under the revised calculation and the old calculation.

2. Revise the leveraged lease calculations as in alternative 1 above with the exception that the calculation would reflect a \$70 residual at the end of the lease term and \$30 of proceeds received when paid by the speculators.
3. Record the \$30 as a deferred credit to be taken into income at the end of the lease as additional sales proceeds for the residual.

Although merits exist for each of the three alternatives, assuming that the equity participant has no new obligations with respect to the disposition of the residual at the end of the lease (i.e., merely providing speculator with any upside benefit when it is realized), we believe that alternative 1 most closely follows the leveraged lease model. The sale of the upward appreciation of the residual does not represent an upward adjustment of the residual value. Instead, it represents the monetization of a previously unvalued and unrecorded asset.

If, in the above example, the lessor had sold the residual value, alternative 2 would best approximate the accounting for such a revision in the timing of cash flows associated with that transaction within the leveraged lease model.

14.2.4.5 Refinancing of non-recourse debt

The interest rate of the non-recourse debt in a leveraged lease transaction is an important assumption in the leveraged lease model. If, as a result of refinancing non-recourse debt (in a lease that is currently classified as a leveraged lease), the lessor's cash flow assumptions change, the revised cash flows under the refinanced debt should be reflected and a cumulative catch-up adjustment recorded as noted in Section 14.2.4.

If the lessor refinances the non-recourse debt subsequent to the inception of the lease and either borrowed an amount greater than the original non-recourse loan principal at the inception of the lease or greater than the existing non-recourse loan principal at the time of the refinancing, we believe it would be inappropriate to treat the borrowings in excess of the outstanding principal at the time of the refinancing as part of the leveraged lease. Instead, such additional borrowings should be recorded separately in the financial statements as opposed to being offset in the net investment in leveraged lease.

14.2.4.6 Changes in a leveraged lease – lease terms

In evaluating the impact of a change in the terms of a leveraged lease, it is first necessary to determine if the change gives rise to a new lease agreement as defined in ASC 840-10-35-4 (see Section 3.4). As a result, the test to determine if a change in a lease agreement gives rise to a "new agreement", as enumerated in Section 5.1.4, should be performed. If the changes to the lease are not determined to give rise to a new lease, the change in the lease payment stream, assuming the change affects the estimated total net income from the lease, should be reflected as a change in an important assumption as discussed in Section 14.2.4.

14.2.5 Applicability of leveraged lease accounting to real estate

Real estate leases and leases in sale-leaseback transactions are not precluded from being classified as leveraged leases if the criteria in ASC 840-10-25-43(c) (see Section 14.1) are met. See Section 6 for further discussion of leases involving real estate.

14.2.6 Leveraged lease accounting for an existing asset

Excerpt from Accounting Standards Codification

Leases – Overall

Implementation Guidance and Illustrations

840-10-55-45

This guidance addresses how a lessor should apply the requirements of paragraph 840-10-25-43(b) and 840-10-25-43(c) to leasing an asset the lessor has owned and had previously placed in service. Paragraph 840-10-25-43(b) requires that the cost or carrying amount, if different, and the fair value of the asset be the same at lease inception for it to be classified as a direct financing lease. Paragraph 840-10-25-43(c)(1) requires that a lease qualify as a direct financing lease for the lessor to classify that lease as a leveraged lease.

840-10-55-46

Although the carrying amount (cost less accumulated depreciation) of an asset previously placed in service may not be significantly different from its fair value, the two amounts will not likely be the same. Therefore, leveraged lease accounting will not be appropriate, generally, other than when an asset to be leased is acquired by the lessor. If the carrying amount of an existing asset of the lessor before any related write-down is equal to fair value as established in transactions by unrelated third parties, that asset could qualify for leveraged lease accounting. However, any write-down to the existing asset's fair value in contemplation of leasing the asset precludes the transaction from leveraged lease accounting.

Leases – Capital Leases

Implementation Guidance and Illustrations

840-30-55-14

As noted in paragraph 840-10-55-46, although the carrying amount of an asset acquired previously may not differ significantly from its fair value, it is unlikely that the two will be the same. However, regulated utilities have argued that the carrying amounts of certain of their assets always equal the fair value based on the utility's ability to recover that cost in conjunction with a franchise to sell a related service in a specified area. That argument is not valid when considering the value of the asset to a third-party purchaser that does not own that franchise, and it is not consistent with paragraph 840-10-25-43(c).

The cost or carrying amount, if different, and the fair value of the asset must be the same at the inception of the lease (see Section 2.2) for it to be classified as a direct financing lease (ASC 840-10-25-43(b)(2) – see Section 14.1). A lease must qualify as a direct financing lease (as opposed to a sales-type or an operating lease) for the lessor to classify that lease as a leveraged lease (ASC 840-10-25-43(c)(1) – see Section 14.1). The criteria for determining if a lease is a direct-financing lease should be applied literally. Although the carrying amount (cost less accumulated depreciation) of an asset previously placed in service may not be significantly different from its fair value, in virtually all cases, the two amounts will not be the same. As such, leveraged lease accounting is generally only appropriate when an asset to be leased is acquired by the lessor. If the carrying amount of an existing asset is equal to fair value as established in transactions by unrelated third parties, that asset could qualify for leveraged lease accounting. However, any write-down to the existing asset's fair value (e.g., an impairment on a preexisting asset) in contemplation of leasing the asset precludes the transaction from leveraged lease accounting.

14.2.7 Requirement for investment to decline and increase

In order to qualify as a leveraged lease, the lessor's net investment must decline during the early years once the investment has been completed and rise during the later years of the lease before its final elimination. ASC 840-30 does not, however, provide guidance as to what magnitude of decline and increase over what period is necessary to meet this requirement. We have generally held the view that the decline and increase must be at least 10% of the initial net investment and that the decline and increase must each last for at least one quarter.

14.2.8 Impact of delayed equity investment on leveraged lease accounting

Excerpt from Accounting Standards Codification

Delayed Equity Investment

In leveraged lease transactions that have been structured with terms such that the lessee's rent payments begin one to two years after lease inception, equity contributions the lessor agrees to make (in the lease agreement or a separate binding contract) that are used to service the nonrecourse debt during this brief period. The total amount of the lessor's contributions is specifically limited by the agreements.

Leases – Overall

Implementation Guidance and Illustrations

840-30-55-15

A delayed equity investment frequently obligates the lessor to make up the shortfall between rent and debt service in the first several years of the transaction. The type of recourse debt resulting from the delayed equity investment does not contradict the notion of nonrecourse under paragraph 840-10-25-43(c)(3) and, therefore, does not preclude leveraged lease accounting as long as other requirements of leveraged lease accounting are met. The lessor's related obligation shall be recorded as a liability at present value at lease inception.

840-30-55-16

Recognition of the liability would increase the lessor's net investment on which the lessor bases its pattern of income recognition. While the increase to the net investment results in an increase in income, it may be offset by the accrual of interest on the liability.

Leveraged lease transactions are sometimes structured with terms such that the lessee's rent payments begin one to two years after inception of the lease. In these transactions, the lessor normally is required to make up the shortfall between rent and debt service in the first several years of the transaction by agreeing, in the lease agreement or a separate binding contract, to make equity contributions that are used to service the non-recourse debt during this brief period. This arrangement is commonly referred to as a delayed equity investment, which typically is limited to the amounts specified, and is measurable at the inception of the lease. The debt is non-recourse to the lessor; however, the creditor frequently has recourse to the lessor's general credit for the debt service contributions. ASC 840-10-25-43(c)(3) (see Section 14.1) specifies that for a leveraged lease, the financing that is provided by the long-term creditor must be non-recourse as to the general credit of the lessor.

The type of recourse debt resulting from the delayed equity investment does not contradict the notion of non-recourse for purposes of qualifying for leveraged lease accounting under ASC 840-10-25-43(c)(3) (see Section 14.1). As such, recourse debt resulting from the delayed equity investment does not preclude leveraged lease accounting as long as other requirements of leveraged lease accounting are met. The lessor's obligation for the delayed equity investment should be recorded as a liability at present

value at the inception of the lease. The lessor's net investment on which the lessor bases its pattern of income recognition would reflect the delayed equity investment (i.e., the net investment would increase due to the recognition of the liability). While the increase to the net investment results in an increase in income, it tends to be offset by the accrual of interest on the liability.

14.2.9

Leveraged lease – comprehensive illustration

ASC 840-30-55-29 through 55-38 provides an illustration of accounting and financial statement presentation for leveraged leases. The illustration begins with a set of assumptions and uses them to prepare an analysis of cash flows by years. This analysis provides the basis for the calculation of the net investment in the leased property. Below is a summarized version of the illustration.

Illustration 14-2: Accounting for leveraged leases

In the illustration, a \$1,000,000 asset is financed by a \$600,000 non-recourse borrowing and \$400,000 of equity investment by the lessor (it is assumed there are no initial direct costs). The components of total income to be earned follows:

Total rentals including residual value	\$ 1,550,000	\$ 1,550,000
Tax depreciation	(1,000,000)	
Loan interest	<u>(516,530)</u>	(516,530)
Taxable income	33,470	
Assumed tax rate/tax effect	X 50.4%	(16,869)
Loan principal		(600,000)
Investment tax credit		100,000
Initial investment		<u>(400,000)</u>
Total lease income		<u>\$ 116,601</u>

The net investment at the beginning of the first year is \$400,000 and the net investment and related deferred taxes at the end of the first year are calculated as follows:

Net Investment:

Initial investment	\$ 400,000
Annual rental	(90,000)
Loan interest and principal payment	74,435
Investment tax credit realized	(100,000)
Income realized (see below):	
Pretax lease income	9,929
Investment tax credit	<u>29,663</u>
	<u>\$ 324,027</u>

Deferred taxes:

First year tax loss:	
Annual rental	\$ 90,000
Tax depreciation	(142,857)
Loan interest	<u>(54,000)</u>
	(106,857)
Assumed tax rate	X 50.4%
	\$ (53,856)
Tax effect of pretax lease income recognized (see below)	<u>(5,004)</u>
	<u>\$ (58,860)</u>

The net investment at the beginning of the second year for purposes of computing income is \$265,167 (\$324,027 net investment less \$58,860, the deferred taxes).

The rate that is applied to each year's beginning net investment in calculating annual income is the sum of the net investment in positive years divided into the total income to be earned on the lease. In the illustration, the total income (\$116,601) is divided by the sum of the positive net investment amounts (\$1,348,477) to produce a rate of 8.647%. This rate is applied to the initial net investment of \$400,000 and results in \$34,588 as the amount of income to be recognized for the first year. The first year's income is allocated to its components based on the relationship of the components of total income to be earned as follows:

Component	Total income	Percent of total		First year income	
				Total	Components
Pretax lease income	\$ 33,470	28.705%	x	\$ 34,588	\$ 9,929
Tax effect of pretax lease income	(16,869)	(14.467)	x	34,588	(5,004)
Investment tax credit	100,000	85.762	x	34,588	29,663
	<u>\$ 116,601</u>	<u>100.000%</u>			<u>\$ 34,588</u>

14.2.10 Presentation of non-recourse debt during construction

Certain build-to-suit transactions, which will ultimately qualify for leveraged lease accounting upon completion, are structured such that the equity is funded at the beginning of the construction period, with the construction financed with non-recourse debt. The question arises as to whether the leveraged lease accounting can "begin" during construction such that the debt would be netted against any construction in progress.

A lease is classified at its inception (date of the lease agreement or commitment if earlier), but recorded on commencement of the lease term. Consistent with this guidance, it is our view that it is not appropriate for the owner-lessor to net the non-recourse debt with construction in progress during the construction period.

14.2.11 Money-over-money lease transactions

Excerpt from Accounting Standards Codification

Leases – Overall

Implementation Guidance and Illustrations

840-30-55-19

A money-over-money lease transaction raises questions as to whether the lessor should recognize a gain for the proceeds from the borrowing in excess of the asset's cost. Other than the recognition of manufacturer's or dealer's profit in a sales-type lease, an entity shall never recognize as income the proceeds from the borrowing in a money-over-money lease transaction at the beginning of the lease term. Accordingly, the entity should account for the transaction as all of the following:

- The manufacture or purchase of an asset
- The leasing of the asset under an operating, direct financing, or sales-type lease
- The borrowing of funds.

840-30-55-20

The asset (if an operating lease) or the lease receivable (if a direct financing or sales-type lease) and the liability for the nonrecourse financing shall not be offset in the statement of financial position unless a right of setoff exists (see Section 210-20-45).

An enterprise manufactures or purchases an asset, leases the asset to a lessee and obtains non-recourse financing in excess of the asset's cost using the leased asset and the future lease rentals as collateral (commonly referred to as a money-over-money lease transaction). Questions have arisen as to whether a lessor in a money-over-money transaction can recognize any of the amount by which the cash received plus the present value of any estimated residual value retained exceeds the carrying amount of the leased asset as profit at the beginning of the lease term. Other than the recognition of manufacturer's or dealer's profit in a sales-type lease, an enterprise should never recognize as income the proceeds from the borrowing in a money-over-money lease transaction at the beginning of the lease term. The enterprise should account for that transaction as (a) the manufacture or purchase of an asset, (b) the leasing of the asset under an operating, direct financing or sales-type lease as required by the lease classification criteria in ASC 840-10-25 and (c) the borrowing of funds. The asset (if an operating lease) or the lease receivable (if a direct financing or sales-type lease) and the liability for the non-recourse financing should not be offset in the statement of financial position unless a right of setoff exists.

14.3

Disclosures

Excerpt from Accounting Standards Codification

Leases – Capital Leases

Disclosure

840-30-50-5

If 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 840-30-25-8 shall be disclosed in the footnotes to financial statements.

840-30-50-5A

For guidance on disclosures about financing receivables, which include receivables relating to a lessor's rights to payments from leveraged leases, see the guidance beginning in paragraphs 310-10-50-5A, 310-10-50-27, and 310-10-50-31.

840-30-50-6

If accounting for the effect on leveraged leases of the change in tax rates results in a significant variation from the customary relationship between income tax expense and pretax accounting income and the reason for that variation is not otherwise apparent, the lessor shall disclose the reason for that variation.

840-30-S99-2

The following is the text of SEC Observer Comment: Effect of a Change in Tax Law or Rates on Leveraged Leases.

Section 840-30-35 requires that all components of a leveraged lease be recalculated from inception of the lease based on the revised after-tax cash flows arising from the change in the tax law, including revised tax rates. The difference between the amounts originally recorded and the recalculated amounts would be included in income of the year in which the tax law is enacted.

This accounting may have distortive effects on the ratio of earnings to fixed charges ("the ratio") as calculated. For example, a favorable after-tax effect might consist of an unfavorable adjustment to pretax income that is more than offset by a favorable adjustment to income tax expense. In those circumstances, despite the overall favorable effect, the ratio as calculated pursuant to the applicable instructions to Item 503(d) of Regulation S-K would be affected negatively because the "earnings" component of the ratio is based on pretax income.

In filings with the Commission the SEC staff will expect the cumulative effect on pretax income and income tax expense, if material, to be reported as separate line items in the income statement. SEC staff will not object to exclusion of an unfavorable pretax adjustment from the "earnings" component of the ratio, in cases in which the after-tax effect is favorable, provided that (1) such exclusion is adequately identified and explained in connection with all disclosures and discussions relating to the ratio and (2) supplemental disclosure is made of the ratio as calculated in accordance with the applicable instructions.

A Abbreviations used in this publication

Abbreviation	<i>FASB Accounting Standards Codification</i>
ASC 360	FASB ASC Topic 360, Property, Plant, and Equipment
ASC 360-10	FASB ASC Subtopic 360-10, Property, Plant, and Equipment -Overall
ASC 360-20	FASB ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales
ASC 405-20	FASB ASC Subtopic 405-20, Liabilities – Extinguishments of Liabilities
ASC 410-20	FASB ASC Subtopic 410-20, Asset Retirement and Environmental Obligations – Asset Retirement Obligations
ASC 420	FASB ASC Topic 420, Exit or Disposal Cost Obligations
ASC 450	FASB ASC Topic 450, Contingencies
ASC 460	FASB ASC Topic 460, Guarantees
ASC 470-50	FASB ASC Subtopic 470-50, Debt – Modifications and Extinguishments
ASC 605	FASB ASC Topic 605, Revenue Recognition
ASC 605-20	FASB ASC Subtopic 605-20, Revenue Recognition – Services
ASC 605-25	FASB ASC Subtopic 605-25, Revenue Recognition – Multiple-Element Arrangements
ASC 740	FASB ASC Topic 740, Income Taxes
ASC 720-15	FASB ASC Subtopic 720-15, Other Expenses – Start-Up Costs
ASC 805	FASB ASC Topic 805, Business Combinations
ASC 810	FASB ASC Topic 810, <i>Consolidations</i>
ASC 815	FASB ASC Topic 815, <i>Derivatives and Hedging</i>
ASC 815-15	FASB ASC Subtopic 815, <i>Derivatives and Hedging – Embedded Derivatives</i>
ASC 820	FASB ASC Topic 820, <i>Fair Value Measurement</i>
ASC 830	FASB ASC Topic 830, <i>Foreign Currency Matters</i>
ASC 835-20	FASB ASC Subtopic 835-20, <i>Interest – Capitalization of Interest</i>
ASC 840	FASB ASC Topic 840, <i>Leases</i>
ASC 845	FASB ASC Topic 845, <i>Nonmonetary Transactions</i>
ASC 853	FASB ASC Topic 853, <i>Service Concession Arrangements</i>
ASC 860	FASB ASC Topic 860, <i>Transfers and Servicing</i>
ASC 970-360	FASB ASC Subtopic 970-360, <i>Real Estate – General – Property, Plant, and Equipment</i>
ASC 976-605	FASB ASC Subtopic 976-605, <i>Real Estate – Retail Land – Revenue Recognition</i>
ASC 980	FASB ASC Topic 980, <i>Regulated Operations</i>
ASC 985-605	FASB ASC Subtopic 985-605, <i>Software – Revenue Recognition</i>

Abbreviation	Other Authoritative Standards
GASB 13	Governmental Accounting Standards Board Statement No. 13, <i>Accounting for Operating Leases with Scheduled Rent Increases</i>
NCGA 5	National Council on Governmental Accounting Statement No. 5, <i>Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments</i>
SAB Topic 13	SEC Staff Accounting Bulletin No. 104, <i>Revenue Recognition</i>

Abbreviation	Non-authoritative Standards
APB 27	APB Opinion No. 27, <i>Accounting for Lease Transactions by Manufacturer or Dealer Lessors</i>
CON 6	FASB Statement of Financial Accounting Concepts No. 6, <i>Elements of Financial Statements</i>
CON 7	FASB Statement of Financial Accounting Concepts No. 7, <i>Using Cash Flow Information and Present Value in Accounting Measurements</i>
EITF 84-37	EITF Issue No. 84-37, "Sale-Leaseback Transaction with Repurchase Option"
EITF 85-27	EITF Issue No. 85-27, "Recognition of Receipts from Made Up Rental Shortfalls"
EITF 86-33	EITF Issue No. 86-33, "Tax Indemnifications in Lease Agreements"
EITF 88-21	EITF Issue No. 88-21, "Accounting for the Sale of Property Subject to the Seller's Preexisting Lease"
EITF 97-10	EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction"
EITF 00-11	EITF Issue No. 00-11, "Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13, <i>Accounting for Leases</i> "
EITF 01-8	EITF Issue No. 01-8, "Determining Whether an Arrangements Contains a Lease"
EITF 04-1	EITF Issue No. 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination"
EITF Topic D-8	EITF Topic No. D-8, "Accruing Bad Debt Expense at Inception of a Lease"
FIN 21	FASB Interpretation No. 21, <i>Accounting for Leases in a Business Combination</i>
FIN 26	FASB Interpretation No. 26, <i>Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease</i>
FIN 45	FASB Interpretation No. 45, <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
FSP FAS 157-1	FASB Staff Position FAS 157-1, <i>Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13</i>
FTB 85-3	FASB Technical Bulletin No. 85-3, <i>Accounting for Operating Leases with Scheduled Rent Increases</i>
FTB 88-1	FASB Technical Bulletin No. 88-1, <i>Issues Relating to Accounting for Leases</i>

Abbreviation	<i>Non-authoritative Standards</i>
Practice Bulletin 1	AcSEC Practice Bulletin 1, <i>Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance</i>
Statement 5	FASB Statement No. 5, <i>Accounting for Contingencies</i>
Statement 13	FASB Statement No. 13, <i>Accounting for Leases</i>
Statement 22	FASB Statement No. 22, <i>Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax Exempt Debt</i>
Statement 27	FASB Statement No. 27, <i>Classification of Renewals or Extensions of Existing Sales Type or Direct Financing Leases</i>
Statement 28	FASB Statement No. 28, <i>Accounting for Sales with Leasebacks</i>
Statement 66	FASB Statement No. 66, <i>Accounting for Sales of Real Estate</i>
Statement 98	FASB Statement No. 98, <i>Accounting for Leases</i>
Statement 109	FASB Statement No. 109, <i>Accounting for Income Taxes</i>
Statement 143	FASB Statement No. 143, <i>Accounting for Asset Retirement Obligations</i>
Statement 157	FASB Statement No. 157, <i>Fair Value Measurements</i>

Abbreviation	<i>Financial Reporting Development</i>
Accounting for derivative instruments and hedging activities FRD	Financial Reporting Developments, <i>Accounting for derivative instruments and hedging activities</i>
Accounting for income taxes FRD	Financial Reporting Developments, <i>Accounting for income taxes</i>
Asset retirement obligations FRD	Financial Reporting Developments, <i>Asset retirement obligations</i>
Business combinations FRD	Financial Reporting Developments, <i>Business combinations, Accounting Standards Codification 805</i>
Consolidation of variable interest entities FRD	Financial Reporting Developments, <i>Consolidation of variable interest entities</i>
Exit or disposal cost obligations FRD	Financial Reporting Developments, <i>Exit or disposal cost obligations, Accounting Standards Codification 420</i>
Fair value measurements and disclosures FRD	Financial Reporting Developments, <i>Fair value measurements and disclosures, Accounting Standards Codification 820</i>
Impairment or disposal of long-lived assets FRD	Financial Reporting Developments, <i>Impairment or disposal of long-lived assets</i>
Multiple-element arrangements FRD	Financial Reporting Developments, <i>Revenue recognition – Multiple-element arrangements</i>
Real estate sales FRD	Financial Reporting Developments, <i>Real estate sales</i>
Real estate project costs FRD	Financial Reporting Developments, <i>Real estate project costs</i>
Software revenue recognition FRD	Financial Reporting Developments, <i>Software- Revenue recognition, Accounting Standards Codification 985-605</i>
Transfers and services of financial assets FRD	Financial Reporting Developments, <i>Transfers and servicing of financial assets, Accounting standards codification 860</i>

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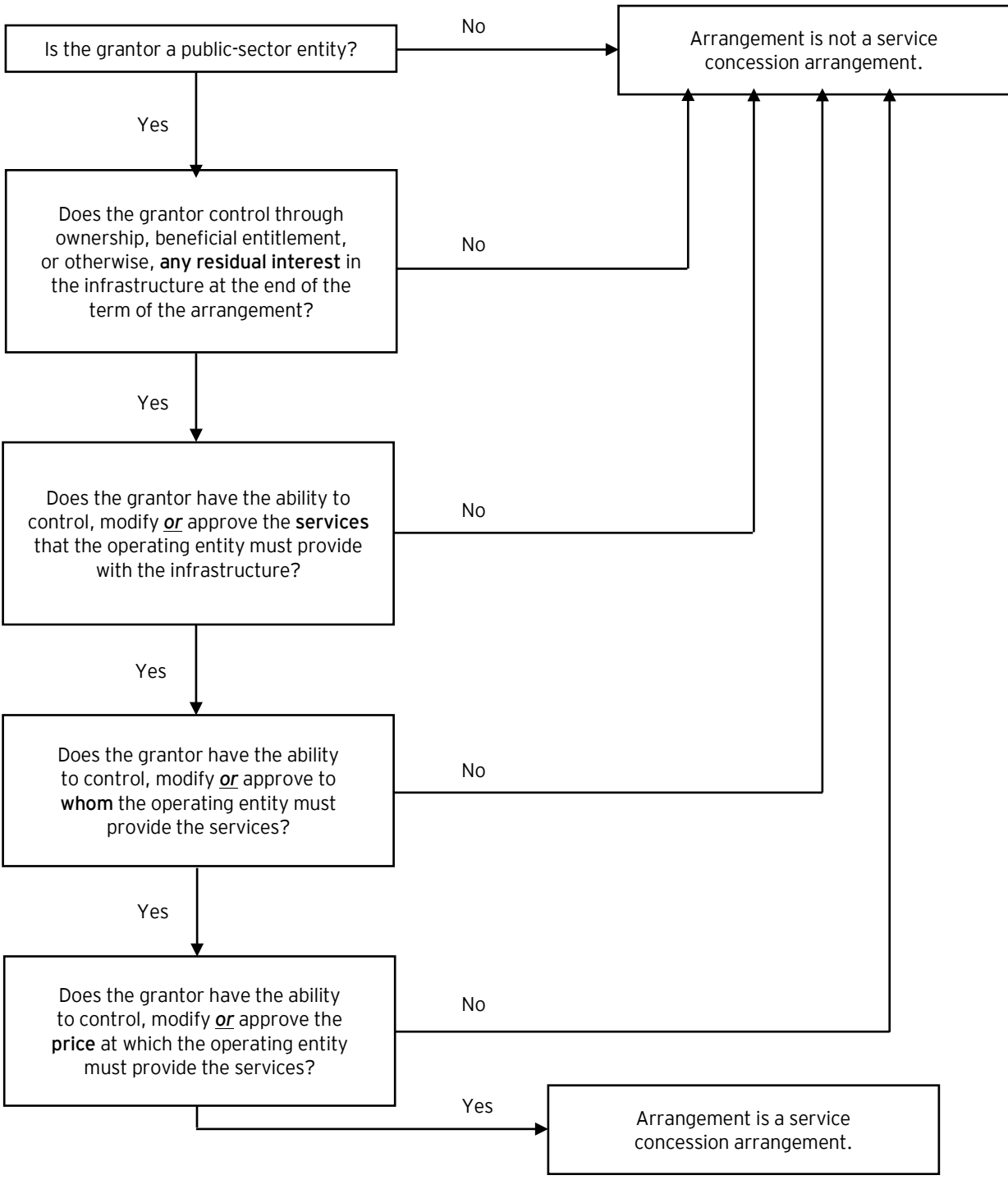
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C

Service concession arrangements (ASC 853) – decision tree for operating entities



D Summary of changes from October 2013 edition

The 2014 edition of our financial reporting developments, *Lease accounting*, has been updated as of 15 November 2014 to include additional authoritative and interpretive guidance not included in the October 2013 edition. Important changes include:

Chapter 1: Scope

- ▶ Section 1.1.3 was updated to note that service concession arrangements in the scope of ASC 853 are excluded from the scope of ASC 840 as a result of the issuance of ASU 2014-05, *Service Concession Arrangements*, which was primarily codified in ASC 853.
- ▶ Section 1.12 was added to address ASU 2014-05.
 - ▶ Section 1.12.1 was added to clarify that a service concession arrangement that meets the scope criteria in ASC 980 (regulated operations) should apply that guidance and not follow the guidance in ASC 853.
 - ▶ Section 1.12.2 was added to address the transition provisions of ASC 853.

Chapter 2: Definitions

- ▶ Section 2.9.1.3 was updated for SEC staff views about how the probability of an event of default under certain non-performance covenants (e.g., material adverse change clauses) should be considered when classifying leases and initially measuring capital lease obligations.
- ▶ Section 2.10 was updated to clarify that the interest rate implicit in a lease may not be the same as the contractually stated or negotiated interest rate.

Chapter 5: Lessor accounting

- ▶ Section 5.1.1 was added to provide illustrative guidance for determining the sales price and interest rate implicit in a sales-type lease.

Appendix C: Service concession arrangements (ASC 853) – decision tree for operating entities

- ▶ Appendix C was added to address ASU 2014-05.

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