Record Request No.: DTE-RR-40

Provide a copy of the entire section on Leases from the GAAP Guide, 2002 Edition.

Response:

See Attachment DTE-RR-40 pages 1 through 32 for the entire section on Leases from the GAAP Guide, 2002 Edition.

Person Responsible: Mark H. Collin

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GAAP GUIDE

Restatement and Analysis of Current FASB Standards

JAN R. WILLIAMS

ASPEN LAW & BUSINESS

CHAPTER 29
LEASES

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For the latest information, refer to the Miller GAAP Update Service *and the* Miller GAAP Library *at www.millerseries.com.*

OVERVIEW

A *lease* is an agreement that conveys the right to use property, usually for a specified period. Leases typically involve two parties: the owner of the property (lessor) and the party contracting to use the property (lessee). Because of certain tax, cash flow, and other advantages, leases have become an important alternative to the outright purchase of property by which companies (lessees) acquire the resources needed to operate.

Leases include agreements that, while not nominally referred to as leases, have the characteristic of transferring the right to use property (e.g., heat supply contracts), and agreements that transfer the right to use property even though the contractor may be required to provide substantial services in connection with the operation or maintenance of the assets.

The term *lease*, as used in promulgated GAAP, does *not* include the following:

- Agreements that are contracts for services that do not transfer the right to use property from one contracting party to another
- Agreements that concern the right to explore for or exploit natural resources such as oil, gas, minerals, and timber
- Agreements that represent licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights

A central accounting issue associated with leases is the identification of those leases that are treated appropriately as sales of the property by lessors and as purchases of the property by lessees (*capital leases*). Those leases that are not identified as capital leases are called *operating leases* and are not treated as sales by lessors and as purchases by lessees. Rather, they are treated on a prospective basis as a series of cash flows from the lessee to the lessor.

GAAP for leases include the largest number of authoritative accounting pronouncements of any single subject in accounting literature. Pronouncements that follow FAS-13 explain, interpret, or amend that pronouncement in a variety of ways; many of them arose as a result of attempts to implement FAS-13. Following are pronouncements that collectively establish promulgated GAAP for lease accounting:

FAS-13	Accounting for Leases
FAS-22	Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt
FAS-23	Inception of the Lease
FAS-27	Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases

FAS-28	Accounting for Sales with Leasebacks
FAS-29	Determining Contingent Rentals
FAS-91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
FAS-98	Accounting for Leases: • Sale-Leaseback Transactions Involving Real Estate • Sales-Type Leases of Real Estate • Definition of the Lease Term • Initial Direct Costs of Direct Financing Leases
FIN-19	Lessee Guarantee of the Residual Value of Leased Property
FIN-21	Accounting for Leases in a Business Combination
FIN-23	Leases of Certain Property Owned by a Governmental Unit or Authority
FIN-24	Leases Involving Only Part of a Building
FIN-26	Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease
FIN-27	Accounting for a Loss on a Sublease

Following is a brief overview of the eight Statements of Financial Accounting Standards included in the promulgated GAAP for leases.

FAS-13 defines a lease as an agreement that conveys the right to use assets (tangible or intangible) for a stated period. A lease that transfers substantially all the benefits and risks inherent in the ownership of property is called a *capital lease*. Such a lease is accounted for by the lessee as the acquisition of an asset and the incurrence of a liability. The lessor accounts for such a lease as a sale (sales-type lease) or financing (direct financing lease). All other leases are referred to as *operating leases*.

FAS-22 addresses an inconsistency between FAS-13 and APB-26 (Early Extinguishment of Debt) arising from refundings of tax-exempt debt, including advance refundings that are accounted for as early extinguishments of debt. FAS-22 is covered in more detail later in this chapter.

FAS-23 amends FAS-13 to specify that, if the leased property is yet to be constructed or acquired by the lessor at the inception of the lease, the lessor's criterion pertaining to "no important uncertainties of unreimbursable costs yet to be incurred by the lessor" is applied at the date that construction of the property is completed or the property is acquired. FAS-23 amends FAS-13 to specify that any increases in the minimum lease payments that have occurred during the preacquisition

or preconstruction period as a result of an escalation clause are to be considered in determining the fair value of the leased property at the inception of the lease. FAS-23 also amends FAS-13 to limit the amount that can be recorded by the lessor for the residual value of leased property to an amount not greater than the estimate as of the inception of the lease. FAS-23 is discussed more fully throughout this chapter.

FAS-27 modifies FAS-13 to require a lessor to classify a renewal or an extension of a sales-type or direct financing lease as a sales-type lease if the lease would otherwise qualify as a sales-type lease and the renewal or extension occurs at or near the end of the lease term. Otherwise, FAS-13 prohibits the classification of a renewal or extension of a sales-type or direct financing lease as a sales-type lease at any other time during the lease term.

FAS-28 amends FAS-13 to specify the appropriate accounting for sale-leaseback transactions depending on the percentage amount of the property that the seller-lessee leases back (substantially all of the property, a minor portion of the property, or more than a minor portion of the property but less than substantially all) and whether the lease is classified as a capital lease or an operating lease.

FAS-29 amends FAS-13 to provide a new definition for *contingent rentals* as those that cannot be determined at the inception of the lease because they depend on future factors or events. Rental payments based on future sales volume, future machine hours, future interest rates, and future price indexes are examples of contingent rentals. Contingent rentals can either increase or decrease lease payments.

FAS-91 establishes accounting and reporting standards for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. Under FAS-91, direct loan origination fees and costs, including initial direct costs incurred by a lessor in negotiating and consummating a lease, are offset against each other and the net amount is deferred and recognized over the life of the loan as an adjustment to the yield on the loan. The provisions of FAS-91 apply to all types of loans, including debt securities, and to all types of lenders, including banks, thrift institutions, insurance companies, mortgage bankers, and other financial and nonfinancial institutions. However, FAS-91 does not apply to nonrefundable fees and costs that are associated with originating or acquiring loans which are carried at market value.

FAS-98 amends FAS-13 to establish a new definition of *penalty* and *lease term* for all leasing transactions. FAS-98 specifies the appropriate accounting for a seller-lessee in a sale-leaseback transaction involving real estate, including real estate with equipment, such as manufacturing facilities, power plants, furnished office buildings, etc. FAS-98 establishes the appropriate accounting for a sale-leaseback transaction in which property improvements or integral equipment is sold to a purchaser-lessor and leased back by the seller-lessee who retains the ownership of the underlying land. FAS-98 also provides the appropriate accounting for sale-leaseback transactions involving real estate with equipment that include separate sale and leaseback agreements for the real estate and the equipment (*a*) with the same entity or related parties and (*b*) that are consummated at or near the same time, suggesting that they were negotiated as a package.

BACKGROUND

Some lease agreements are such that an asset and a related liability should be reported on the balance sheet of the lessee enterprise. The distinction is one of *substance over form* when the transaction actually *transfers substantially all the benefits and risks inherent in the ownership of the property.*

Established in GAAP are criteria to determine whether a lease transaction is in substance a transfer of the incidents of ownership. If, *at its inception*, a lease meets one or more of the following four criteria, the lease is classified as a capital lease:

1. By the end of the lease term, ownership of the leased property is transferred to the lessee.
2. The lease contains a bargain purchase option.
3. The lease term is substantially (75% or more) equal to the estimated useful life of the leased property.
4. At the inception of the lease, the present value of the minimum lease payments, with certain adjustments, is 90% or more of the fair value of the leased property.

These criteria are examined in more detail later in this chapter.

TERMINOLOGY

The authoritative literature includes many terms that are important for an understanding of lease accounting. Several of these terms are explained below.

Capital Lease

A capital lease transfers the benefits and risks inherent in the ownership of the property to the lessee, who accounts for the lease as an acquisition of an asset and the incurrence of a liability (FAS-13, par. 6a).

Sales-Type Lease

A sales-type lease is a type of capital lease that results in a manufacturer's or dealer's profit or loss to the lessor and transfers substantially all the

benefits and risks inherent in the ownership of the leased property to the lessee; in addition, (*a*) the minimum lease payments are reasonably predictable of collection and (*b*) no important uncertainties exist regarding costs to be incurred by the lessor under the terms of the lease (FAS-13, par. 6b).

In a sales-type lease, the *fair value* of the leased property at the inception of the lease differs from the cost or carrying amount because a manufacturer's or dealer's profit or loss exists. Fair value usually is the *normal selling price* of the property.

Direct Financing Lease

A direct financing lease is a type of capital lease that does *not* result in a manufacturer's or dealer's profit or loss to the lessor, but does transfer substantially all the benefits and risks inherent in the ownership of the leased property to the lessee; in addition, (*a*) the minimum lease payments are reasonably predictable of collection and (*b*) no important uncertainties exist regarding costs to be incurred by the lessor under the terms of the lease (FAS-13, par. 6b).

Separately identifying sales-type and direct financing leases is an accounting issue for the lessor only, who accounts for the two types of capital leases differently, as described later in this chapter. Both types of leases transfer substantially all the benefits and risks inherent in the ownership of the leased property to the lessee, who records the transaction as a *capital lease.*

Fair Value

Fair value is the price for which the leased property could be sold between unrelated parties in an arm's-length transaction (FAS-13, par. 5c).

For the manufacturer or dealer, fair value usually is the normal selling price less trade or volume discounts. Fair value may be less than the normal selling price, however, and sometimes less than the cost of the property.

For others, fair value usually is cost less trade or volume discounts. Fair value may be less than cost, however, especially in circumstances in which a long period elapses between the acquisition of the property by the lessor and the inception of a lease.

Fair Rental

Fair rental is the rental rate for similar property under similar lease terms and conditions.

Related Parties

Related parties are one or more entities subject to the significant influence over the operating and financial policies of another entity (FAS-13, par. 5a).

Executory Costs

Executory costs are items such as insurance, maintenance, and taxes paid in connection with the leased property (FAS-13, par. 5j).

Bargain Purchase Option

A bargain purchase option is a lessee's option to purchase the leased property at a sufficiently low price that makes the exercise of the option relatively certain (FAS-13, par. 5d).

Bargain Renewal Option

A bargain renewal option is a lessee's option to renew the lease at a sufficiently low rental that makes the exercise of the option relatively certain (FAS-13, par. 5e).

Estimated Economic Life

Estimated economic life is the estimated remaining useful life of the property for the purpose for which it was intended, regardless of the term of the lease (FAS-13, par. 5g).

Estimated Residual Value

Estimated residual value is the estimated fair value of the leased property at the end of the lease term. The estimated residual value shall not exceed the amount estimated at the inception of the lease except for the effect of any increases that result during the construction or preacquisition period, because of escalation provisions in the lease (FAS-13, par. 5h).

Unguaranteed Residual Value

Unguaranteed residual value is the estimated fair value of the leased property at the end of the lease term that is not guaranteed by either

the lessee or a third party unrelated to the lessor. A guarantee by a third party related to the lessee is considered a lessee guarantee (FAS-13, par. 5i).

Lessee's Incremental Borrowing Rate

The lessee's incremental borrowing rate is the rate of interest that the lessee would have had to pay at the inception of the lease to borrow the funds, on similar terms, to purchase the leased property (FAS-13, par. 51).

Inception of Lease

The inception of the lease is the date of the lease agreement *or* the date of a written commitment signed by the parties involved that sets forth the principal provisions of the lease transaction. A written commitment that does not contain all of the principal provisions of the lease transaction does not establish the inception date (FAS-23, par. 6).

Interest Rate Implicit in the Lease

The interest rate implicit in the lease is the rate that, when applied to certain items (enumerated below), results in an aggregate present value equal to the fair value of the leased property at the beginning of the lease term, less any investment credit expected to be realized and retained by the lessor. The discount rate is applied to (*a*) the minimum lease payments, excluding executory costs such as insurance, maintenance, and taxes (including any profit thereon) that are paid by the lessor and (*b*) the estimated fair value of the property at the end of the lease term, exclusive of any portion guaranteed by either the lessee or a third party unrelated to the lessor (unguaranteed residual value) (FAS-13, par. 5k).

Initial Direct Costs

The definition of *initial direct costs* is as follows (FAS-91, par. 24):

> *Initial direct costs.** Only those costs incurred by the lessor that are (*a*) costs to originate a lease incurred in transactions with independent third parties that (i) result directly from and are essential to acquire that lease and (ii) would not have been incurred had that leasing transaction not occurred and (*b*) certain costs directly related to specified activities performed by the lessor for that lease. Those activities are: evaluating the prospective lessee's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating lease terms; preparing and processing lease documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs shall not include costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Initial direct costs shall not include administrative costs, rent, depreciation, any other occupancy and equipment costs, and employees' compensation and fringe benefits related to activities described in the previous sentence, unsuccessful origination efforts, and idle time.
>
> *Initial direct cost shall be offset by nonrefundable fees that are yield adjustments as prescribed in FAS-91.

In determining the net amount of initial direct costs in a leasing transaction under FAS-13, a lessor shall apply the provisions of FAS-91 relating to loan origination fees, commitment fees, and direct loan origination costs of completed loans. Initial direct costs are accounted for by lessors as part of the investment in a direct financing lease.

> **OBSERVATION:** The recognition of a portion of the unearned income at the inception of a lease transaction to offset initial direct costs is not permitted (FAS-91, par. 23).

Contingent Rentals

Contingent rentals are those that cannot be determined at the inception of the lease because they depend on future factors or events. Rental payments based on future sales volume, future machine hours, future interest rates, and future price indexes are examples of contingent rentals. Contingent rentals can either increase or decrease lease payments (FAS-29, par. 11).

Increases in minimum lease payments that occur during the preacquisition or construction period as a result of an escalation clause in the lease are not considered contingent rentals.

Lease Term

The lease term includes all of the following (FAS-98, par. 22a):

1. Any fixed noncancelable term
2. Any period covered by a bargain renewal option
3. Any period in which penalties are imposed in an amount that at the inception of the lease reasonably assures the renewal of the lease by the lessee
4. Any period covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt that is directly or indirectly related to the leased property is expected to be in effect or a loan from the lessee to the lessor that is directly or indirectly related to the leased property is expected to be outstanding

   Note: The phrase *indirectly related to the leased property* is used to cover situations 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.
5. Any period covered by ordinary renewal options preceding the date on which a bargain purchase option is exercisable
6. Any period representing renewals or extensions of the lease at the lessor's option

A lease term does not extend beyond the date a bargain purchase option becomes exercisable.

Noncancelable Lease Term

A noncancelable lease term is a provision in a lease agreement that specifies that the lease may be canceled only (*a*) on some remote contingency, (*b*) with permission of the lessor, or (*c*) if the lessee enters into a new lease with the same lessor (FAS-98, par. 22a).

Penalty

The term *penalty* refers to any outside factor or provision of the lease agreement that does or can impose on the lessee the requirement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment (FAS-98, par. 22b).

MINIMUM LEASE PAYMENTS

Normal minimum lease payments for the lessee include (FAS-13, par. 5j):

1. The minimum rent called for during the lease term
2. Any payment or guarantee that the lessee must make or is required to make concerning the leased property at the end of the lease term (residual value), including:
   a. Any amount stated to purchase the leased property
   b. Any amount stated to make up any deficiency from a specified minimum
   c. Any amount payable for failure to renew or extend the lease at the expiration of the lease term

When a lease contains a *bargain purchase option,* the minimum lease payments include only (*a*) the *minimum rental payments over the lease term* and (*b*) *the payment required to exercise the bargain purchase option.*

The following are excluded in determining minimum lease payments (FAS-13, par. 5j):

1. A guarantee by the lessee to pay the lessor's debt on the leased property
2. The lessee's obligation (separate from the rental payments) to pay executory costs (insurance, taxes, etc.) in connection with the leased property
3. Contingent rentals (FAS-29, par. 10)

OBSERVATION: FIN-19 clarifies certain guarantees of the residual value of leased property made by a lessee, as follows:

1. A guarantee by a lessee to make up a residual value deficiency caused by damage, extraordinary wear and tear, or excessive usage is similar to a contingent rental, since the amount is not determinable at the inception of the lease. Therefore, this type of lessee guarantee does not constitute a lessee guarantee of residual value for purposes of computing the lessee's minimum lease payments (FIN-19, par. 3).
2. A lessee's guarantee to make up a residual value deficiency at the end of a lease term is limited to the specified maximum deficiency called for by the lease (FIN-19, par. 4).
3. Unless the lessor explicitly releases the lessee, a guarantee of residual value by an unrelated third party for the benefit of the lessor does not release the obligation of the lessee. Therefore, such a guarantee by an unrelated third party

shall not be used to reduce the lessee's minimum lease payments. Costs incurred in connection with a guarantee by an unrelated third party are considered executory costs and are not included in computing the lessee's minimum lease payments (FIN-19, par. 5).

The minimum lease payments to a lessor are the sum of (FAS-13, par. 5j):

1. The minimum lease payments under the lease terms
2. Any guarantee by a third party, unrelated to the lessee and lessor, of the residual value or rental payments beyond the lease term, providing such guarantor is financially capable of discharging the potential obligation

LEASE CLASSIFICATION

Lessees

If one or more of the following four criteria is present at the inception of a lease, it is classified as a capital lease by the lessee (FAS-13, par. 7):

1. Ownership of the property is transferred to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term, at inception, is substantially (75% or more) equal to the estimated economic life of the leased property, including earlier years of use. (*Exception:* This criterion cannot be used for a lease that begins within the last 25% of the original estimated economic life of the leased property. *Example:* A jet aircraft that has an estimated economic life of 25 years is leased for five successive five-year leases. If the first four five-year leases were classified as operating leases, the last five-year lease cannot be classified as a capital lease, because the lease would commence within the last 25% of the estimated economic life of the property and would fall under this exception.)
4. The present value of the minimum lease payments at the beginning of the lease term, excluding executory costs and profits thereon to be paid by the lessor, is 90% or more of the fair value of the property at the inception of the lease, less any investment tax credit retained and expected to be realized by the lessor. (*Exception:* This criterion cannot be used for a lease that begins within the last 25% of the original estimated economic life of the leased property.)

A lessee's incremental borrowing rate is used to determine the present value of the minimum lease payments, except that the lessor's implicit rate of interest is used if it is known and it is lower (FAS-13, par. 7d).

☛ **PRACTICE POINTER:** While the criteria for identifying a capital lease appear very specific, significant professional judgment must be exercised in implementing them. For example:

- Except in the simplest cases, determining the lease term may involve judgment.
- Several of the criteria include terms that require judgment when they are applied to a specific lease. These include "bargain purchase option," "estimated useful life of the property," and "fair value of the property."
- The lease term and the present value of minimum lease payments criteria are not available for leases that begin within the last 25% of the asset's estimated useful life, which is subject to judgment.
- Determining the minimum lease payments for the lessee may require use of that party's incremental borrowing rate, which may involve judgment.

Lessors

If, at inception, a lease meets any one (or more) of the four criteria indicating that substantially all the benefits and risks of ownership have been transferred to the lessee, and it *meets both the following conditions*, the lease is classified by the lessor as a sales-type or direct financing lease, whichever is appropriate:

1. *Collection of the minimum lease payments is reasonably predictable.* A receivable resulting from a lease subject to an estimate of uncollectibility based on experience is not precluded from being classified as either a sales-type or a direct financing lease (FAS-98, par. 22f).
2. *No important uncertainties exist for unreimbursable costs yet to be incurred by the lessor under the lease.* Important uncertainties include extensive warranties and material commitments beyond normal practice. *Executory costs*, such as insurance, maintenance, and taxes, are not considered important uncertainties (FAS-13, par. 8b).

   Note: In the event the leased property is not acquired or constructed before the inception of the lease, this condition is not applied until such time as the leased property is acquired or constructed by the lessor (FAS-23, par. 7).

In applying the fourth basic capitalization criterion—the present value of the lease equals or exceeds 90% of the fair value of the property—a lessor computes the present value of the minimum lease payments, using the interest rate *implicit in the lease* (FAS-13, par. 7d).

A lease involving real estate is not classified by the lessor as a sales-type lease unless the title to the leased property is transferred to the lessee at or shortly after the end of the lease term (FAS-98, par. 22c).

Classification of a lease as a capital or operating lease is summarized in Figure 29-1.

CHANGING A PROVISION OF A LEASE

If a change in a provision of a lease results in a different lease classification at the inception of the lease because it meets different criteria, a new lease agreement is created that must be reclassified according to its different criteria. Renewal, extension, or a new lease under which the lessee continues to use the same property is not considered a change in a lease provision (FAS-13, par. 9).

Any action that extends the lease term, except to void a residual guarantee, or a penalty for failure to renew the lease at the end of the lease term, is considered a new lease agreement that is classified according to the different criteria.

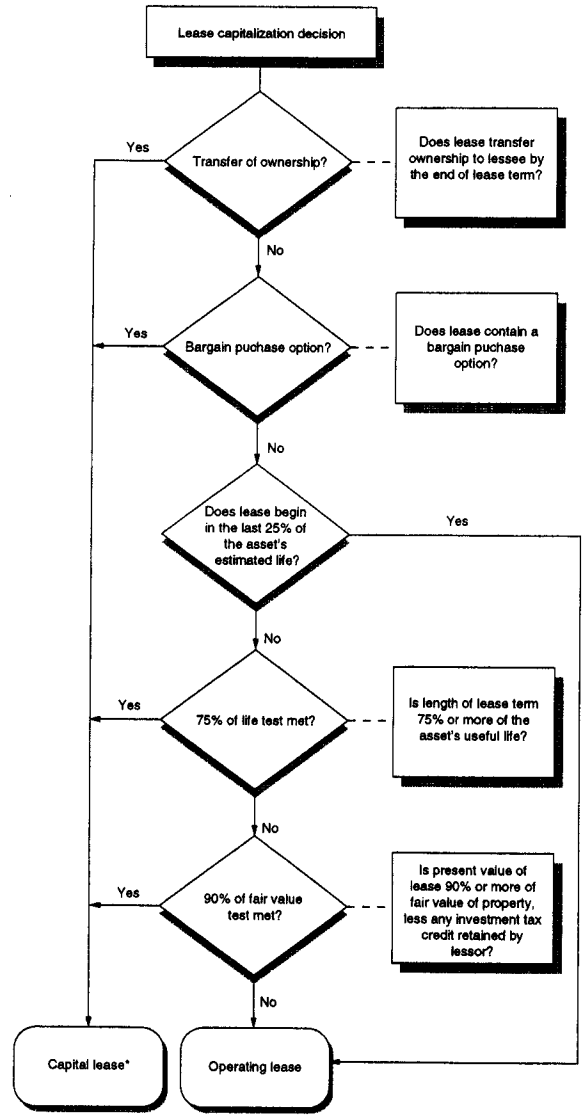
Changes in estimates or circumstances do not cause a reclassification.

Refunding of Tax-Exempt Debt

If a change in a lease occurs as a result of a refunding by the lessor of tax-exempt debt and (*a*) the lessee receives the economic advantages of the refunding, and (*b*) the revised lease qualifies and is classified either as a capital lease by the lessee or as a direct financing lease by the lessor, the change in the lease shall be accounted for on the basis of whether or not an extinguishment of debt has occurred, as follows (FAS-22, par. 12):

1. Accounted for as an extinguishment of debt:
   a. The lessee adjusts the lease obligation to the present value of the future minimum lease payments under the revised agreement, using the effective interest rate of the new lease agreement. Any gain or loss is treated as a gain or loss on an early extinguishment of debt.
   b. The lessor adjusts the balance of the minimum lease payments receivable and the gross investment in the lease (if affected) for the difference between the present values of the old and new or revised agreement. Any gain or loss is recognized in the current period.

Figure 29-1: Classification of a Lease as a Capital or Operating Lease



*Lessor must determine that two additional criteria are met to account for the lease as a capital lease:

1. Collection of minimum lease payments is reasonably predictable.
2. No important uncertainties exist for unreimbursable costs to be incurred by the lessor.

2. Not accounted for as an extinguishment of debt:
   a. The lessee accrues any costs connected with the refunding that are obligated to be reimbursed to the lessor. The interest method is used to amortize the costs over the period from the date of the refunding to the call date of the debt to be refunded.
   b. The lessor recognizes as revenue any reimbursements to be received from the lessee for costs paid related to the debt to be refunded over the period from the date of the refunding to the call date of the debt to be refunded.

ACCOUNTING AND REPORTING BY LESSEES

Capital Leases

Initial Recording

The lessee records a capital lease as an asset and a corresponding liability. The initial recording value of a lease is the *lesser* of the fair value of the leased property or the present value of the minimum lease payments, excluding any portion representing executory costs and profit thereon to be paid by the lessor. Fair value is determined as of the inception of the lease, and the present value of the minimum lease payments is computed at the beginning of the lease term. The inception of the lease and the beginning of the lease term are not necessarily the same dates (FAS-13, par. 10).

Since the lessee's minimum lease payments *exclude* a lessee's obligation to pay executory costs, executory costs paid by the lessee are expensed as paid or appropriately accrued. If such costs are included in the rental payments and are not identified separately (which is the most likely case), an estimate of the amount is necessary.

A lessee's incremental borrowing rate is used to determine the present value of the minimum lease payments unless the lessor's implicit rate of interest is known and is lower (FAS-13, par. 7d).

Leases with Escalation Clauses

In lease agreements or written commitments in which the leased property is to be acquired or constructed by the lessor, there may be a provision for the escalation of the minimum lease payments during the construction or preacquisition period. Usually, the escalation is based on increased costs of acquisition or construction of the leased property. A provision to escalate the minimum lease payments during the construction or preacquisition period can also be based on other measures of cost or value, including general price-level changes or changes in the consumer price index.

The relationship between the total amount of minimum lease payments and the fair value of a lease is such that when one increases so does the other. For example, assume that the total minimum lease payments of a particular lease are $100,000 payable in five equal annual installments, and the fair value of the same lease is $350,000. If the minimum lease payments are increased 20% to $120,000, it is likely that the fair value of the lease will increase correspondingly, because the lease is then worth more to an investor.

FAS-23 requires that increases in the minimum lease payments that occur during the preacquisition or construction period as a result of an escalation clause be considered in determining the fair value of the leased property at the inception of the lease for the purposes of the initial recording of the lease transaction by the lessee, or where fair value is used as a basis of allocation (FAS-23, par. 8).

The initial recording value of a lease transaction by the lessee, which is required by FAS-13, is the lesser of the fair value of the leased property or the present value of the minimum lease payments. FAS-23 changes the lessee's determination of fair value for leases that contain escalation clauses from the fair value on the inception date to a fair value amount that includes the effect of any increases which have occurred as a result of the escalation clause. The changes embodied in FAS-23 are intended to create lease classifications that more closely reflect the substance of a lease transaction.

OBSERVATION: The question arises as to when leases of this type should be recorded on the books of the lessee. FAS-23 appears to indicate that the initial recording should be made only after the effects of the escalation clause on the fair value of the leased property are determined. Otherwise, FAS-23 is silent in all respects as to when the lease transaction should be recorded. In the case of significant amounts of leases, it appears illogical to wait several years to record the transaction. If this is the only viable alternative, however, full disclosure of all pertinent facts pertaining to the lease agreement or commitment should be made in a prominent footnote.

The other alternative is to record these types of lease transactions immediately at the inception of the lease, utilizing whatever information is available and subsequently adjusting the recorded amounts when the effects of the escalation clauses are known. This alternative does not appear to be viable because of the difficulties mentioned in the following paragraphs.

The last-enumerated criterion in FAS-13 for capitalizing a lease is when the present value of the minimum lease payments is 90% or more of the fair value of the leased property at the inception of the lease. When this criterion is considered for capitalizing a lease in conjunction with the alternative of recording lease transactions covered by FAS-23 at the inception of the lease and then subsequently adjusting the recorded amounts when the effects of the

escalation clauses become known, the following problems arise, which are not addressed by either FAS-13 or FAS-23.

1. If we assume that FAS-23 requires that the fair value of leases with escalation clauses be determined at a future date, what fair value should be used to determine whether the lease is or is not a capital lease in accordance with the criterion of whether the present value of the minimum lease payments is 90% or more of the fair value of the leased property at the inception of the lease?

2. What if a lease of this type is capitalized in accordance with the criterion that the present value of the minimum lease payments is 90% or more of the fair value at inception of the lease, and subsequently, as a result of the escalation clause, the present value becomes less than 90% of the fair value, so that the lease should not have been capitalized?

3. Suppose a lease with an escalation clause is properly classified as an operating lease at inception of the lease and subsequently, as a result of the escalation clause, the lease qualifies as a capital lease.

The above are just a few of the complications that could arise in applying the provisions of FAS-23 to lease transactions.

FAS-23 also permits increases in the estimated residual value (see definition) that occur as a result of escalation provisions in leases in which the leased property is to be acquired or constructed by the lessor. For example, if the estimated residual value is 10% of the fair value at the inception of a lease and during the construction or preacquisition period of the leased property the effects of the escalation clause increase the fair value, then the estimated residual value also is allowed to increase above the amount that was estimated at the date of the inception of the lease (FAS-23, par. 9).

Amortization

The asset recorded under a capital lease is amortized in a manner consistent with the lessee's normal depreciation policy for other owned assets. The period for amortization is either (*a*) the estimated economic life or (*b*) the lease term, depending on which criterion was used to classify the lease. If the criterion used is either of the first two criteria (ownership of the property is transferred to the lessee by the end of the lease term or the lease contains a bargain purchase option), the asset is amortized over its estimated economic life. In all other cases, the asset is amortized over the lease term. Any *estimated residual value* is deducted from the asset to determine the amortizable base (FAS-13, par. 11).

☛ **PRACTICE POINTER:** Determining the appropriate amortization period for capital leases is an important issue where the lease term is significantly less than the expected useful life of the asset. A simple rule of thumb is simply to determine which party to the lease is expected to have use of the property during the period between the end of the lease period and the end of the expected life of the asset. If the lease is capitalized by the first or second capitalization criteria (transfer of title and bargain purchase option), the underlying assumption is that the lessee will become the legal owner of the asset by the end of the lease term and will have use of it for the remainder of the asset's expected life. Thus, the estimated life of the asset is the logical period of amortization. On the other hand, an assumption of the transfer of legal title does not underlie the lease if it is capitalized because of the third or fourth criteria (lease term and the present value of minimum lease payments). In either of these circumstances, the lease term is the logical period for amortization of the leased asset. Generally, if the same lease satisfies one or both of the first two criteria and one or both of the second criteria, use the expected life of the asset as the period of amortization.

Interest Expense: Interest Method

The interest method, sometimes referred to as the *effective interest method,* is used to produce a constant rate of interest on the remaining lease liability. A portion of each minimum lease payment is allocated to interest expense and/or amortization, and the balance is applied to reduce the lease liability. Any *residual guarantee(s)* by the lessee or penalty payments are automatically taken into consideration by using the interest method and will result in a balance at the end of the lease term equal to the amount of the guarantee or penalty payments at that date (FAS-13, par. 12).

Illustration of Interest Method

Jones Company leases a tractor-trailer for $8,000 per year on a noncancelable five-year lease. Jones guarantees to the lessor that the tractor-trailer will have a residual value of at least $5,000 at the end of the lease term.

Assume that all other assumptions have been eliminated and that a 12% interest rate is used.

Present value of $8,000 payments for five years at 12%	=	$28,838*
Present value of $5,000 guaranteed residual value in five years at 12%	=	2,837**
Total asset and lease obligation		$31,675

* $8,000 x 3.60478
**$5,000 x .56743

A schedule of interest expense, amortization, and reduction of the lease obligation of $31,675 to the $5,000 residual guarantee using the interest method follows:

Book Value Lease Obligation Beginning of Year	*Rental Payments*	*12% Interest on Beginning Book Value*	*Reduction in Lease Obligation*	*Book Value Lease Obligation End of Year*
$31,675	$ 8,000	$ 3,801	$ 4,199	$27,476
27,476	8,000	3,297	4,703	22,773
22,773	8,000	2,733	5,267	17,506
17,506	8,000	2,101	5,899	11,607
11,607	8,000	1,393	6,607	5,000
	$40,000	$13,325	$26,675	

Change in Lease Terms

If a guarantee or penalty is rendered inoperative because of a renewal or other extension of the *lease term*, or if a new lease is consummated in which the lessee continues to lease the same property, an adjustment must be made to the asset and lease obligation for the difference between the present values of the old and the revised agreements. In these cases, the present value of the future minimum lease payments under the new or revised agreement is computed using the original rate of interest on the initial lease (FAS-13, par. 12).

Other lease changes are accounted for as follows (FAS-13, par. 14):

1. If a lease change results in revised minimum lease payments, but also is classified as a capital lease, an adjustment is made to the asset and lease obligation for the difference between the present values of the old and the new or revised agreement. The present value of the future minimum lease payments under the new or revised agreement is computed using the original rate of interest used on the initial lease.
2. If a new or revised agreement results from a lease change and is classified as an operating lease, gain or loss is recognized and the asset and lease obligation is eliminated from the books of account.
3. A renewal, extension, or new lease under which the lessee continues to use the same property, except when a guarantee or penalty is rendered inoperative (see above), is accounted for as follows:
   a. *Renewal or extension classified as a capital lease:* An adjustment is made for the difference between the original and revised present values, using the original discount rate.

   b. *Renewal or extension classified as an operating lease:* The existing lease continues to be accounted for as a capital lease to the end of its lease term, and the renewal or extension is accounted for as an operating lease.

When leased property under a capital lease is purchased by the lessee, it is accounted for as a renewal or extension of a capital lease. Thus, any difference between the carrying amount and the purchase price on the date of purchase is treated as an adjustment of the carrying amount of the property (FIN-26, par. 5).

Termination of a Lease

Gain or loss, if any, is recognized on the termination of a capital lease, and the asset and lease liability is removed from the books (FAS-13, par. 14).

Illustration of Capital Lease (Lessee)

Paine Corporation leases a computer under a noncancelable five-year lease for annual rental payments of $10,000. The fair value of the computer at the inception of the lease is $36,048, and the incremental borrowing rate of Paine is 10%. There are no executory costs, and no investment tax credit is available. The annual rent of $10,000 is considered a fair rental as opposed to a bargain rental. The estimated economic life of the computer is 10 years.

Classification of Lease

A review is made of the criteria involved in the provisions of the lease to determine its classification.

1. Criterion (1) is not met, because there is no transfer of the ownership of the leased property before the end of the lease term.
2. Criterion (2) is not met, because the lease does not contain a bargain purchase option.
3. Criterion (3) is not met, because the lease term (five years) is not equal to 75% or more of the estimated economic life (10 years) of the leased property. [**Note:** There are no other provisions affecting the lease term other than the five-year noncancelable term.]
4. Criterion (4) is met, because the present value ($37,908) of the minimum lease payments, excluding executory costs and profits thereon paid by the lessor, is 90% or more of the fair value ($36,048) of the leased property. [**Note:** The present value computations are given below.]

Paine Corporation should record the transaction as a capital lease.

Accounting for the Lease

The initial recording value of the leased property, at the inception of the lease, is the lesser of the fair value of the leased property or the present value of the minimum lease payments, excluding any portion that represents executory costs and profit thereon to be paid by the lessor.

The discount rate used by the lessee to find the present value of the minimum lease payments is its incremental borrowing rate of 10%, unless the lessee has knowledge of the lessor's implicit interest rate in the lease, and that rate is lower.

The lessor's interest rate implicit in the lease in this example is 12%. As a rule, the interest rate implicit in the lease is equal to the discount rate that, when applied to the minimum lease payments of $10,000 per year for five years and, if any, the unguaranteed residual value of the leased property, results in a present value equal to the fair value of the leased property at the inception of the lease. (For simplicity, this definition excludes any unusual factors that a lessor might recognize in determining its rate of return.)

This means that Paine must use its incremental borrowing rate of 10% to discount the minimum lease payments to their present value, which is $37,908.

The initial recording value of the leased property is the lesser of the fair value of the leased property at inception or the present value of the minimum lease payments using the lower interest rate. Therefore, the $36,048 fair value is less than the minimum lease payments of $37,908 (computed by using the lower incremental borrowing rate) and is used to initially record the lease, as follows:

Lease property, capital leases	$36,048	
Obligations, capital leases		$36,048

Amortization by Lessee

The asset(s) recorded under a capital lease is amortized in a manner consistent with lessee's normal depreciation policy for other owned assets. The period for amortization is either (*a*) the estimated economic life or (*b*) the lease term, depending on which criterion was used to classify the lease. If the criterion used to classify the lease as a capital lease was either criterion (1) (ownership of the property is transferred to the lessee by the end of the lease term) or criterion (2) (lease contains a bargain purchase option), the asset is amortized over its economic life. In all other cases, the asset is amortized over the lease term. Any residual value is deducted from the asset to determine the amortizable base.

Since the Paine Corporation's lease qualified under criterion (4) (present value of the minimum lease payments, excluding executory costs and profit thereon paid by the lessor, is 90% or more of the fair value of the leased property), the amortization period is over the lease term.

A schedule of amortization, interest expense, and lease obligation payments for Paine Corporation's computer lease, using the interest method, follows:

Book Value Lease Obligation Beginning of Year	*Rental Payments*	*12% Interest on Beginning Book Value*	*Amortization*	*Book Value Lease Obligation End of Year*
$36,048	$10,000	$ 4,326	$ 5,674	$30,374
30,374	10,000	3,645	6,355	24,019
24,019	10,000	2,882	7,118	16,901
16,901	10,000	2,028	7,972	8,929
8,929	10,000	1,071	8,929	—
	$50,000	$13,952	$36,048	

Note: The interest rate used is 12%, which is the interest rate implicit in the lease.

Operating Leases

Leases that do not qualify as capital leases in accordance with the provisions of FAS-13 are classified as operating leases. The cost of property covering an operating lease is included in the lessor's balance sheet as property, plant, and equipment. FAS-13 requires that rental income and expense relating to an operating lease be amortized over the periods in which the lessee derives benefit from the physical usage of the leased property. Thus, rental expense is amortized over the lease term on a straight-line basis, unless some other systematic and rational basis is more representative of the time pattern in which the benefits of the leased property are derived by the lessee (FAS-13, par. 15).

☛ **PRACTICE POINTER:** Use care when implementing accounting standards for sales-type leases involving real estate. FAS-98 amended FAS-13 to require that the lessor shall not classify a lease involving real estate as a sales-type lease unless title to the leased property is transferred to the lessee at or shortly after the end of the lease term. As a result, a lessor may be required to classify a lease involving real estate as an operating lease, instead of a sales-type lease, because the lease agreement does not provide for the transfer of the leased property to the lessee by the end of the lease term. In this event, the lessor must recognize a loss at the inception of an operating lease involving real estate if the fair value of the leased property is less than its cost or carrying amount, whichever is applicable. The amount of loss is equal to the difference between the fair value of the leased property and its cost or carrying amount at the inception of the lease.

Contingent Rental Expense

Some operating lease agreements provide for rental increases or decreases based on one or more future conditions, such as future sales volume, future machine hours, future interest rates, or future price indexes. These types of rental increases or decreases are classified as *contingent rentals.* Contingent rentals are defined as those that cannot be determined at the inception of the lease because they depend on future conditions or events. A lessee's contingent rental payments are deducted as an expense in the period in which they arise (FAS-29, par. 11).

Scheduled Rent Increases or Decreases

To accommodate the lessee, a lessor may structure an operating lease agreement to provide for smaller rental payments in the early years of the lease and higher rental payments toward the end of the lease. *Example:* A six-year operating lease agreement may provide for rental payments of $1,000 per month for the first two years; $1,500 per month for the next two years; and $2,000 per month for the last two years; for a total rental payment of $108,000 for the six years. Under this circumstance, FAS-13 requires that the $108,000 total rental payments be amortized over the six-year lease term on a straight-line basis. The monthly amortization for the first two years of the lease term is $1,500, even though only $1,000 per month is paid by the lessee under the terms of the lease (FAS-13, par. 15).

> **OBSERVATION:** A reasonable argument can be made that in the early years of the above type of lease agreement, the lessee receives not only the use of the leased property, but also the temporary use of cash, equal to the excess of the fair rental value of the leased property over the actual rental payments. Theoretically, to recognize the economic substance of this lease transaction, both the lessee and the lessor should record imputed interest on the difference between the actual amount of rental payments and the computed amount of level rental payments. FAS-13, however, precludes the use of the time value of money as a factor in recognizing rentals under operating leases.

Right to Control Physical Use of Leased Property

In accounting for leases, there is a significant distinction between lease agreements that grant the lessee the right to control the use of the leased property at the beginning of the lease term and lease agreements that do not. A lease agreement may contain a rent escalation clause that is based on the lessee's utilization of the leased property. *Example:* A lease agreement covering a 10,000 square foot warehouse provides for a rent

increase at the time the lessee utilizes more than 5,000 square feet of the warehouse. In this example, the lessee has control of the entire leased property at the beginning of the lease term. On the other hand, a lease agreement may contain a rent escalation clause for property that was originally leased, which becomes effective at the time the lessee leases additional property from the lessor. For example, a master lease provides for an increase in rent on property that was originally leased, at the time the lessee leases additional property from the lessor. In this example, the lessee does not have control of the additional leased property at the beginning of the lease term.

The right to control the use of leased property is considered to be the equivalent of the physical use of the property. In a lease agreement that gives the lessee control of the use of the leased property from the beginning of the lease term, the lessee and the lessor recognize, as part of the minimum lease payments, rental expense and rental revenue, including escalated amounts, on a straight-line basis over the lease term. On the other hand, when the lease agreement provides for the lessee to gain control over additional property, the escalated rent related to the original leased property is accounted for by the lessee as rental expense on the original 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 lessor recognizes the escalated rents on the original leased property as additional rental revenue.

Lease Incentives in Operating Leases

To induce a prospective tenant to lease property, a lessor may offer (*a*) to make cash payments directly to the prospective tenant, (*b*) to reimburse the prospective tenant's moving expenses, or (*c*) to assume the obligation of the prospective tenant to a third party under a preexisting lease. These inducements are accounted for as either (*a*) an incentive for the lessee and an incentive for the lessor or (*b*) a reduction of rental expense by the lessee and a reduction of rental revenue by the lessor. Incentives or concessions that are paid to, or incurred by, the lessor on behalf of the lessee are accounted for as reductions of rental expense and/or rental revenue and recognized over the term of the new lease on a straight-line basis.

Losses incurred by the lessor as a result of assuming the lessee's obligation to a third party under a preexisting lease are accounted for as incentives by both the lessor and the lessee. In this circumstance, the lessee and the lessor shall estimate independently the amount of loss related to the assumption of the preexisting lease with a third party. The lessee may estimate the amount of loss related to the incentive by comparing the new lease to the prevailing market rate for similar leased property or by comparing the prevailing market rate for similar property reduced by the value of the lease obligation assumed by the new lessor. The lessor may estimate the amount of loss related to the

incentive by subtracting from the total assumed obligation the expected benefits, if any, that the new lessor may derive from the use of the assumed leased property, including income from a sublease.

Illustration of Lease Incentives

As an incentive to execute a new operating lease for eight years, a lessor assumes the obligation on the lessee's preexisting lease which has four years remaining. The new lease payments are $8,000 per year and the lease payments on the lessee's preexisting lease are $6,000 per year. The estimated loss on the assumption of the lessee's preexisting lease is $2,400 based on the fact that the lessor can sublease the property for $450 per month for the remaining four years left on the lease. Based on a comparison with current market rates for similar leased property, the lessee calculates its amount of estimated loss as $1,600 for the remaining four years left on the lease.

The following are the lessor's and lessee's journal entries relating to this lease transaction:

Lessor Accounting

Incentive to lessee	$2,400	
Liability on sublease assumed		$2,400
To record deferred cost and liability at the inception of the lease, related to the loss on assumption of remaining lease.		
Liability on sublease assumed ($2,400/4 years)	$ 600	
Sublease expense ($450 x 12 months)	5,400	
Cash		$6,000
To record cash payment on sublease assumed and amortization of the liability on the sublease assumed.		

[**Note:** The above journal entry is an annualized version of entries that may be recorded monthly.]

Cash	$5,400	
Sublease revenue ($450 x 12 months)		$5,400
To record cash received from sublease of property.		

[**Note:** The above journal entry is an annualized version of entries that may be recorded monthly.]

Cash	$8,000	
Rental revenue		$7,700
Incentive to lessee ($2,400/8 years)		300

[**Note:** The above journal entry is an annualized version of entries that may be recorded monthly.]

Lessee Accounting

Loss on sublease assumed by lessor	$1,600	
Incentive from lessor		$1,600
To record loss on sublease assumed by lessor in conjunction with new lease.		
Lease expense	$7,800	
Incentive from lessor ($1,600/8 years)	200	
Cash		$8,000
To record cash payment on new lease and amortization of incentive over the new lease.		

[**Note:** The above journal entry is an annualized version of entries that may be recorded monthly.]

Financial Statement Disclosure

General Disclosure

A general description of the lessee's leasing arrangements, including (*a*) basis of contingent rental payments; (*b*) terms of renewals, purchase options, and escalation clauses; and (*c*) restrictions imposed by lease agreements, such as additional debt, dividends, and leasing limitations, must be disclosed (FAS-13, par. 16).

Capital Leases

Assets, accumulated amortization, and liabilities from capital leases are reported separately in the balance sheet and classified as current or noncurrent in the same manner as other assets and liabilities (FAS-13, par. 13).

Current amortization charges to income must be disclosed clearly, along with additional information (FAS-13, par. 16):

1. *Gross assets:* as of each balance sheet date presented, in aggregate and by major property categories (this information may be combined with comparable owned assets)
2. *Minimum future lease payments:* in total and for each of the next five years, showing deductions for executory costs, including any profit thereon, and the amount of imputed interest to reduce the net minimum lease payments to present values
3. *Minimum sublease income:* due in future periods under noncancelable subleases

4. Total contingent rentals actually incurred for each period for which an income statement is presented

Operating Leases

The following financial statement disclosure is required for all operating leases of lessees having noncancelable lease terms in excess of one year (FAS-13, par. 16):

1. *Minimum future rental payments:* in total and for each of the next five years
2. *Minimum sublease income:* due in future periods under noncancelable subleases
3. *Schedule of total rental expense:* showing the composition by minimum rentals, contingent rentals, and sublease income (excluding leases with terms of a month or less that were not renewed)

Following is an illustration of a lessee's financial statement disclosure (using assumed numbers).

Illustration of Lessee's Financial Statement Disclosure

Lessee's Balance Sheet
(in thousands)

	December 31	
	20X1	*20X0*
Assets:		
Leased property:		
Capital leases, less accumulated amortization (Note:_____)	$ 2,200	$ 1,600
Liabilities:		
Current:		
Obligations under capital leases (Note:_____)	$ 365	$ 340
Noncurrent:		
Obligations under capital leases (Note:_____)	$ 1,368	$ 1,260

Capital Leases
Gross Assets and
Accumulated Amortization
(in thousands)

	December 31	
	20X1	*12X0*
Type of Property		
Manufacturing plants	$ 1,500	$ 1,100
Retail stores	1,200	840
Other	300	210
Total	$ 3,000	$ 2,150
Less: Accumulated amortization	800	550
Capital leases, net	$ 2,200	$ 1,600

Capital Leases
Minimum Future Lease
Payments and Present Values of the
Net Minimum Lease Payments
(in thousands)

Year Ended December 31	
20X2	$ 406
20X3	1,232
20X4	160
20X5	125
20X6	100
After 20X6	450
Total minimum lease payments	$ 2,473
Less: Executory costs (estimated)	250
Net minimum lease payments	$ 2,223
Less: Imputed interest	490
Present value of net minimum lease payments	$ 1,733

In addition to the foregoing statements and schedules, footnotes describing minimum sublease income and contingent rentals should be included, if required.

Operating Leases
Schedule of Minimum Future Rental Payments
(in thousands)

Year Ended December 31	
20X2	$ 815
20X3	2,400
20X4	320
20X5	250
20X6	200
After 20X6	900
Total minimum future rental payments	$ 4,885

In addition to the above information on operating leases, a note should be included describing minimum sublease income due in the future under noncancelable subleases.

Operating Leases
Composition of Total Rental Expense
(in thousands)

	December 31	
	20X1	*20X0*
Minimum rentals	$1,100	$1,050
Contingent rentals	100	125
Less: Sublease rental income	(200)	(150)
Total rental expense, net	$1,000	$1,025

Note: The above schedule of total rental expense excludes leases with terms of one month or less that were not renewed.

In addition to the foregoing information on capital and operating leases, a footnote describing the general disclosure policy for the lessee's leases should be included, containing (*a*) general leasing arrangements, (*b*) basis of contingent rental payments, (*c*) terms of renewals, purchase options, and escalation clauses, and (*d*) restrictions imposed by lease agreements, such as additional debt, dividends, and leasing limitations.

ACCOUNTING AND REPORTING BY LESSORS

Leases are classified for the lessor as either (*a*) sales-type, (*b*) direct financing, or (*c*) operating. Both sales-type and direct financing are forms of capital leases.

Sales-type leases usually are used by sellers of property to increase the marketability of expensive assets. The occurrence of a manufacturer's or dealer's profit or loss generally is present in a sales-type lease.

Direct financing leases do not give rise to a manufacturer's or dealer's profit or loss, and the fair value usually is the cost or the carrying amount of the property.

Capital Leases

Recording Sales-Type Leases

The lessor's *gross investment* in the lease is the sum of (*a*) the lessor's minimum lease payments less any executory costs and profit thereon to be paid by the lessor and (*b*) any unguaranteed residual value accruing to the benefit of the lessor (this is the estimated fair value of the leased property at the end of the lease term, which is not guaranteed). (**Note:** If the residual value is guaranteed, it is included in the minimum lease payments) (FAS-13, par. 17a).

The estimated residual value used to compute the unguaranteed residual value accruing to the benefit of the lessor shall not exceed the amount estimated at the inception of the lease (FAS-13, par. 17d).

Using the interest rate implicit in the lease, the lessor's gross investment in the lease is discounted to its present value. The present value of the lessor's gross investment in the lease represents the sales price of the property that is included in income for the period. (**Note:** When using the interest rate implicit in the lease, the present value will always be equal to the fair value) (FAS-13, par. 17c).

The cost or carrying amount of the property sold plus any initial direct costs (costs incurred by the lessor to negotiate and consummate the lease, such as legal fees and commissions), less the present value of the unguaranteed residual value (if any) accruing to the benefit of the lessor is charged against income in the period in which the corresponding sale is recorded (FAS-13, par. 17c).

The difference between the lessor's gross investment in the lease and the sales price of the property is recorded as unearned income, which is amortized to income over the lease term by the interest method. The unearned income is included in the balance sheet as a deduction from the related gross investment, which results in the net investment in the lease (FAS-13, par. 17b).

A lease involving real estate is not classified by the lessor as a sales-type lease unless the title to the leased property is transferred

to the lessee at or shortly after the end of the lease term (FAS-98, par. 22c).

Recording Direct Financing Leases

The lessor's *gross investment* in the lease is computed, which is equal to the sum of (*a*) the lessor's minimum lease payments less any executory costs and profit thereon to be paid by the lessor and (*b*) any unguaranteed residual value accruing to the benefit of the lessor (this is the estimated fair value of the lease property at the end of the lease term, which is not guaranteed). If the residual value is guaranteed, it is included in the minimum lease payments (FAS-98, par. 22h).

Under FAS-91, loan origination fees and direct loan origination costs, including initial direct costs incurred by the lessor in negotiating and consummating the lease, are offset against each other and the resulting net amount is deferred and recognized over the life of the loan as an adjustment to the yield on the loan (FAS-91, par. 5).

The difference between the lessor's gross investment in the lease and the cost or carrying amount of the leased property, if different, is recorded as unearned income, which is amortized to income over the lease term by the interest method. The unearned income is included in the balance sheet as a deduction from the related gross investment, which results in the net investment in the lease (FAS-98, par. 22i).

> **OBSERVATION:** The practice of recognizing a portion of the unearned income at the inception of the lease to offset initial direct costs is no longer acceptable (FAS-91, par 5).

Balance Sheet Classification

The resulting net investment in both sales-type and direct financing leases is subject to the same treatment as other assets in classifying as current or noncurrent (FAS-98, par. 22i).

Annual Review of Residual Values

The unguaranteed residual values of both sales-type and direct financing leases should be reviewed at least annually to determine whether a decline, other than temporary, has occurred in their estimated values. If a decline is not temporary, the accounting for the transaction should be revised using the new estimate, and the resulting loss should be recognized in the period that the change is made. *Upward adjustments are not allowed* (FAS-13, pars. 17d and 18d).

Accounting for Lease Changes

The definition of *lease term* includes any periods in which penalties are imposed in an amount that reasonably assures the renewal of the lease by the lessee. The definition of *minimum lease payments* includes any payments or guarantees that the lessee is required to make concerning the leased property, including any amount (*a*) to purchase the leased property, (*b*) to make up any deficiency from a specified minimum, and (*c*) for failure to renew or extend the lease at the expiration of the lease term. Guarantees and penalties such as these usually are canceled and become inoperative in the event the lease is renewed or extended or a new lease for the same property is consummated.

If a sales-type or direct financing lease contains a residual guarantee or a penalty for failure to renew and is rendered inoperative as a result of a lease renewal or other extension of the lease term, or if a new lease is consummated in which the lessee continues to lease the same property, an adjustment must be made to the unearned income account for the difference between the present values of the old and the revised agreements. The present value of the future minimum lease payments under the new agreement is computed by using the original rate of interest used for the initial lease (FAS-13, par. 17e).

In sales-type and direct financing leases that do not contain residual guarantees or penalties for failure to renew, an adjustment is made to account for lease changes, renewals, or other extensions, including a new lease in which the lessee continues to lease the same property. If the classification of the lease remains unchanged or is classified as a direct financing lease and the amount of the remaining minimum lease payments is changed, an adjustment is made to unearned income to account for the difference between the present values of the old and the new agreements (FAS-13, par. 17f). If a new classification results in a sales-type lease, it is classified and treated as a direct financing lease, unless the transaction occurs within the last few months of the original lease, in which case it is classified as a sales-type lease (FAS-27, par. 6).

If the classification of a lease is changed to an operating lease, the accounting treatment depends upon whether the operating lease starts immediately or at the end of the existing lease. If the operating lease starts immediately, the remaining net investment is eliminated from the accounts and the leased property is recorded as an asset using the lower of (*a*) original cost, (*b*) present fair value, or (*c*) present carrying amount. The difference between the remaining net investment and the new recorded value of the asset is charged to income in the period of change (FAS-13, par. 17f).

If the operating lease starts at the end of the existing lease, the existing lease continues to be accounted for as a sales-type or direct financing lease until the new operating lease commences, at which time the accounting treatment is the same as if the operating lease started immediately. Renewals and extensions usually commence at

the end of the original sales-type or direct financing lease. Under these circumstances there should not be any remaining investment to eliminate from the books and the leased property is not recorded as an asset (FAS-13, par. 17f).

Termination of a Lease

Termination of a lease is recognized in the income of the period in which the termination occurs by the following journal entries (FAS-13, par. 17f):

1. The remaining net investment is eliminated from the accounts.
2. The leased property is recorded as an asset using the lower of the (*a*) original cost, (*b*) present fair value, or (*c*) present carrying amount.

Operating Leases

Leases that do not qualify as capital leases in accordance with the provisions of FAS-13 are classified as operating leases. The cost of the property leased to the lessee is included in the lessor's balance sheet as property, plant, and equipment. The lessor's income statement will normally include the expenses of the leased property (unless it is a net lease), such as depreciation, maintenance, taxes, insurance, and other related items. Material initial direct costs (those directly related to the negotiation and consummation of the lease) are deferred and allocated to income over the lease term (FAS-13, pars. 19a and 19c).

FAS-13 requires that rental income from an operating lease be amortized over the periods in which the lessor's benefits in the leased property are depleted. Thus, rental income is amortized over the lease term on a straight-line basis, unless some other systematic and rational basis is more representative of the time pattern in which the benefits of the leased property are depleted (FAS-13, par. 19b).

FAS-98 amended FAS-13 to require that a lease involving real estate not be classified by the lessor as a sales-type lease unless title to the leased property is transferred to the lessee at or shortly after the end of the lease term. As a result, an enterprise may be required to classify a lease involving real estate as an operating lease, instead of a sales-type lease, because the lease agreement does not provide for the transfer of the leased property to the lessee by the end of the lease term. In this event, the lessor recognizes a loss at the inception of an operating lease involving real estate if the fair value of the leased property is less than its cost or carrying amount, whichever is applicable. The amount of loss is equal to the difference between the fair value of the leased property and its cost or carrying amount at the inception of the lease (FAS-98, par. 22c).

Contingent Rental Income

Contingent rental income is defined as that which cannot be determined at the inception of the lease because it depends on future conditions or events. A lessor's contingent rental income is accrued in the period in which it arises (FAS-29, par. 13).

Money-Over-Money Operating Lease Transactions

A money-over-money lease transaction is one in which a lessor manufactures or purchases an asset, leases the asset to a lessee, and obtains nonrecourse financing in excess of the asset's cost using the leased asset and the future lease rentals as collateral. A money-over-money lease transaction may result either in (*a*) an operating lease, (*b*) a direct financing lease, or (*c*) a sales-type lease.

A lessor shall account for a money-over-money lease transaction as (*a*) the purchase or manufacture of an asset, (*b*) the leasing of that asset under an operating lease, direct financing lease, or sales-type lease in accordance with the provisions of FAS-13, and (*c*) the borrowing of funds.

If a money-over-money transaction results in an operating lease, the lessor records an asset and liability on its statement of financial position. If the transaction results in a direct financing lease or a sales-type lease, the lessor records a lease receivable and a liability on its statement of financial position.

Residual Value of a Leased Asset

Lease brokers or other enterprises may acquire an interest in the residual value of a leased asset by the payment of cash, the assumption of liabilities, and/or the payment of other consideration, including services rendered by the lease broker.

An interest in the residual value of a leased asset may be acquired by an enterprise in the form of an unconditional interest in the leased asset or the right to receive all or a portion of the proceeds from the sale of the leased asset at the end of the lease term without acquiring the related lease. For example, a lease broker may receive an interest in the residual value of a leased asset as a fee for services rendered. An interest in the residual value of a leased asset can also be acquired directly from a lessor. For example, a lessor may sell substantially all of the minimum rental payments associated with a sales-type, direct

financing, or leveraged lease and retain an interest in the residual value of the leased asset.

The acquisition of an interest in the residual value of a leased asset generally includes the right to receive all or part of the future benefit that may be derived from the residual value of the leased asset. For example, an enterprise may acquire from a lessor the unconditional right to own and possess, at the end of the lease term, an asset subject to a lease; or an enterprise may acquire 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. Both of these transactions should be recorded as the acquisition of an asset, since both transactions involve the acquisition of an interest in the residual value of a leased asset.

The cost of an interest in the residual value of a leased asset is measured by (*a*) the amount of cash disbursed, (*b*) the fair value of other consideration given, and (*c*) the present value of liabilities assumed at the date the right is acquired. If it is more clearly evident, however, the fair value of the interest in the residual value of the leased asset at the date of the agreement is used instead of the fair value of the assets surrendered, services rendered, or liabilities assumed.

An enterprise accounts for the acquisition of an interest in the residual value of a leased asset at no more than the acquisition cost of the asset. Furthermore, an enterprise does not recognize any increases in the residual value of the leased asset over the remaining term of the related lease, regardless of the lessor's classification and accounting for the leased asset.

If in subsequent periods there is a decline, other than temporary, in the fair value of the interest in the residual value of a leased asset, the carrying amount of the asset is reduced to the new fair value and the amount of write-down recognized as a current loss. In this event, the new fair value becomes the new carrying amount for the asset, and the new carrying amount shall not be increased in any subsequent period prior to the sale or other disposition of the interest in the residual value of the leased asset.

After the sale of substantially all of the minimum rental payments of a sales-type, direct financing, or leveraged lease, a lessor reports any remaining interest in the residual value of the lease at its carrying amount at the date of the sale of the lease payments. In addition, the lessor does not recognize any increases in the residual value of the leased asset over the remaining term of the related lease.

If in subsequent periods there is a decline, other than temporary, in the fair value of the interest in the residual value of a leased asset, the carrying amount of the asset is reduced to the new fair value and the amount of write-down recognized as a current loss. In this event, the new fair value becomes the new carrying amount for the asset, and the new carrying amount is not increased in any subsequent period prior to the sale or other disposition of the interest in the residual value of the leased asset.

A guarantee of the residual value of a leased asset does not change the nature of an interest in the residual value of a leased asset or its historical acquisition cost.

Lease Sale or Assignment to Third Parties

Sale or assignment of a sales-type or a direct financing lease does not negate the original accounting treatment. Profit or loss is recognized at the time of sale or assignment, unless the seller assumes *substantial risks* (FAS-13, par. 20).

Frequently, a sale of property *subject to an operating lease* is complicated by some type of indemnification agreement by the seller. The seller may guarantee that the property will remain leased or may agree to reacquire the property if the tenant does not pay the specified rent. These types of transactions cannot be accounted for as a sale because of the substantial risk assumed by the seller. The principle of *substance over form* must be applied to such situations and treated accordingly. Examples of *substantial risk* on the part of the seller are (FAS-13, par. 21):

1. Agreements to reacquire the property or lease
2. Agreements to substitute another existing lease
3. Agreements to use "best efforts" to secure a replacement buyer or lessee

Examples of *nonsubstantial risk* situations on the part of the seller are (FAS-13, par. 21):

1. Execution of a remarketing agreement that includes a fee for the seller
2. Situations in which the seller does not give priority to the releasing or other disposition of the property owned by a third party

If a sale to a third-party purchaser is not recorded as a sale because of the substantial risk factor assumed by the seller, it is accounted for as a *borrowing*. The proceeds from the "sale" are recorded as an obligation on the books of the seller. Rental payments made by the lessee under the operating lease are recorded as revenue to the seller, even if the rentals are paid to the third party. Each rental payment shall consist of imputed interest, and the balance of the payment shall be applied as a reduction of the obligation. Any sale or assignment of lease payments under an operating lease is accounted for as a borrowing (FAS-13, par. 22).

Financial Statement Disclosure

The following financial statement disclosure is required by lessors whose *significant business activity is leasing* (not including *leveraged* leasing):

General Disclosures

General disclosures for leases of lessors: a general description of the lessor's leasing arrangements FAS-13, par. 23c).

Capital Leases

For sales-type and direct financing leases (FAS-13, par. 23a and FAS-91, par. 25d):

1. A schedule of the components of the *net investment* in leases, as of each balance sheet date, including:
   a. Future minimum lease payments
   b. Executory costs
   c. Allowance for uncollectibles
   d. Unguaranteed residual values accruing to the benefit of the lessor
   e. Unearned income
   f. Contingent rentals
2. A schedule of the minimum lease payments, in total and for the next five years

Operating Leases

For operating leases (FAS-13, par. 23b):

1. A schedule of the investment in property on operating leases, and property held for lease, by major categories, less accumulated depreciation, as of each balance sheet presented
2. A schedule of future minimum rentals on noncancelable operating leases, in total and for each of the next five years
3. The amount of contingent rentals included in each income statement presented

Following is an illustration of a lessor's disclosure (using assumed numbers).

Illustration of Lessor's Financial Statement Disclosure

Lessor's Balance Sheet
(in thousands)

	December 31	
	20X1	*20X0*
Assets:		
Current assets:		
Net investment in sales-type and direct financing leases (Note:___)	$ 208	$ 200
Noncurrent assets:		
Net investment in sales-type and direct financing leases (Note:___)	$ 972	$ 830
Property on operating leases and property held for leases (net of accumulated depreciation of $450 and $400 for 20X1 and 20X0, respectively) (Note:___)	$1,800	$1,600

Schedule of Components—Net Investment in Leases Sales-Type and Direct Financing Leases
(in thousands)

	20X1	*20X0*
Total minimum lease payments receivable	$1,450	$1,250
Less: Estimated executory costs, including profit thereon	150	125
Minimum lease payments	$1,300	$1,125
Less: Allowance for uncollectibles	65	60
Net minimum lease payments receivable	$1,235	$1,065
Add: Estimated unguaranteed residual values of leased properties	240	215
	$1,475	$ 1280
Less: Unearned income	295	250
Net investment in sales-type and direct financing leases	$1,180	$1,030

A footnote should be included for contingent rentals.

Schedule of Minimum Lease Payments
(in thousands)

Year Ended December 31	
20X2	$ 260
20X3	195
20X4	156
20X5	132
20X6	125
After 20X6	432
Total minimum lease payments receivable, net of executory costs	$1,300

Schedule of Investment in Property on Operating Leases and Property Held for Lease (by Major Class Categories)
(in thousands)

Data-processing equipment	$ 900
Transportation equipment	700
Construction equipment	400
Other	200
Total	$2,200
Less: Accumulated depreciation	400
Net investment	$1,800

Schedule of Future Minimum Rentals on Noncancelable Operating Leases
(in thousands)

Year Ended December 31	
20X2	$ 200
20X3	175
20X4	165
20X5	125
20X6	110
After 20X6	200
Total future minimum rentals	$ 975

A footnote should be included for contingent rentals.

LEASES INVOLVING REAL ESTATE

Leases involving real estate are categorized as follows (FAS-13, par. 24):

1. Land only
2. Land and building(s)
3. Land, building(s), and equipment
4. Only part of a building(s)

Review of Classification of Leases by Lessees

A review of the classifications of leases by lessees is necessary because accounting for leases involving real estate depends primarily on the criteria for classifying leases.

If one or more of the following four criteria are present at the inception of a lease, it is classified as a capital lease by the lessee:

1. Ownership of the property is transferred to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term, at inception, is substantially (75% or more) equal to the estimated economic life of the leased property, including earlier years of use. (*Exception:* This criterion cannot be used for a lease that begins within the last 25% of the original estimated economic life of the leased property.)
4. The present value of the minimum lease payments at the beginning of the lease term, excluding executory costs and profits thereon to be paid by the lessor, is 90% or more of the fair value of the property at the inception of the lease, less any investment tax credit retained and expected to be realized by the lessor. (*Exception*: This criterion cannot be used for a lease that begins within the last 25% of the original estimated economic life of the leased property.)

These criteria are referred to by number in the following discussion.

Leases Involving Land Only

A *lessee* accounts for a lease involving land only as a capital lease if either criterion (1) or criterion (2) is met. All other leases involving land only are classified as operating leases by the lessee.

A *lessor* classifies a lease involving land only as a sales-type lease and accounts for the transaction as a sale under the provisions of FAS-66, if the lease gives rise to a manufacturer's or dealer's profit (or loss) and criterion (1) is met. A lessor classifies a lease involving land only as a direct financing lease or a leveraged lease, whichever is applicable, if the lease does not give rise to a manufacturer's or dealer's profit (or loss), criterion (1) is met, and (*a*) the collection of the minimum lease payments is reasonably predictable and (*b*) no important uncertainties exist regarding costs yet to be incurred by the lessor under the lease. A lessor classifies a lease involving land only as a direct financing lease, a leveraged lease, or an operating lease, whichever is applicable, if criterion (2) is met, and (*a*) the collection of the minimum lease payments is reasonably predictable and (*b*) no important uncertainties exist regarding costs yet to be incurred by the lessor under the lease. All other leases involving land only are classified as operating leases by the lessor (FAS-98, par. 22k).

Leases Involving Land and Building(s)

Leases involving land and building(s) may be categorized as follows:

A. Leases that meet criterion (1) or criterion (2)
B. Leases in which the fair value of the land is less than 25% of the total fair value of the leased property at the inception of the lease
C. Leases in which the fair value of the land is 25% or more of the total fair value of the leased property at the inception of the lease

A. Leases That Meet Criterion (1) or Criterion (2)

Leases that meet either criterion (1) or criterion (2) are accounted for as follows:

Lessee The present value of the minimum lease payments, less executory costs and profits thereon (to be paid by the lessor), is allocated between the land and building(s) in proportion to their fair value at the inception of the lease. The present value assigned to the building(s) is amortized in accordance with the lessee's normal depreciation policy (FAS-13, par. 26a).

Lessor If a lease gives rise to a manufacturer's or dealer's profit (or loss) and criterion (1) is met, a lessor classifies a lease involving land and building(s) as a sales-type lease and accounts for the transaction as a sale under the provisions of FAS-66. If a lease does not give rise to a manufacturer's or dealer's profit (or loss) and criterion (1) is met, a lessor classifies a lease involving land and building(s) as a direct financing lease or a leveraged lease, whichever is applicable, providing that (*a*) collection of the minimum lease payments are reasonably predictable and (*b*) no important uncertainties exist regarding costs yet to be incurred by the lessor under the lease (FAS-98, par. 22l).

If a lease gives rise to a manufacturer's or dealer's profit (or loss) and criterion (2) is met, a lessor classifies a lease involving land and building(s) as an operating lease. If the lease does not give rise to a manufacturer's or dealer's profit (or loss) and criterion (2) is met, a lessor classifies a lease involving land and building(s) as a direct financing lease or a leveraged lease, whichever is applicable, providing that (*a*) collection of the minimum lease payments is reasonably predictable and (*b*) no important uncertainties exist regarding costs yet to be incurred by the lessor under the lease (FAS-98, par. 22l).

All other leases involving land and building(s) are classified as operating leases by the lessor.

B. Fair Value of the Land Is Less Than 25% of the Total Fair Value of the Leased Property at the Inception of the Lease

When applying criteria (3) and (4), both the lessee and the lessor consider the land and building(s) as a single unit, and the estimated economic life of the building(s) is the estimated economic life of the single unit. This type of lease is accounted for as follows:

Lessee The land and building(s) are accounted for as a single capitalized asset and amortized in accordance with the lessee's normal depreciation policy over the lease term if either criterion (3) or criterion (4) is met (FAS-13, par. 26b).

Lessor If a lease gives rise to a manufacturer's or dealer's profit (or loss) and criterion (3) or criterion (4) is met, a lessor classifies a lease involving land and building(s), in which the fair value of the land is less than 25% of the total fair value of the leased property at the inception of the lease as an operating lease. If the lease does not give rise to a manufacturer's or dealer's profit (or loss) and criterion (3) or criterion (4) is met, a lessor classifies a lease involving land and building(s) in which the fair value of the land is less than 25% of the total fair value of the leased property at the inception of the lease as a direct financing lease or a leveraged lease, whichever is applicable, providing that (*a*) collection of the minimum lease payments is reasonably predictable and (*b*) no important uncertainties exist regarding costs yet to be incurred by the lessor under the lease. All other leases involving land and building(s) are classified as operating leases by the lessor (FAS-98, par. 22m).

C. Fair Value of the Land Is 25% or More of the Total Fair Value of the Leased Property at the Inception of the Lease

When applying criteria (3) and (4), both the lessee and the lessor shall consider the land and building(s) separately. To determine the separate

values of the land and building(s), the lessee's incremental borrowing rate is applied to the fair value of the land to determine the annual minimum lease payments applicable to the land. The balance of the minimum lease payments remaining is attributed to the building(s). This type of lease is accounted for as follows (FAS-13, par. 26b):

Lessee The building(s) portion is accounted for as a capital lease and amortized in accordance with the lessee's normal depreciation policy over the lease term if the building(s) portion meets either criterion (3) or criterion (4). The land portion is accounted for separately as an operating lease.

Lessor If a lease gives rise to a manufacturer's or dealer's profit (or loss) and criterion (3) or criterion (4) is met, a lessor classifies a lease involving land and building(s) in which the fair value of the land is 25% or more of the total fair value of the leased property at the inception of the lease as an operating lease. If the lease does not give rise to a manufacturer's or dealer's profit (or loss) and criterion (3) or (4) is met, a lessor shall classify the building(s) portion of a lease in which the fair value of the land is 25% or more of the total fair value of the leased property at the inception of the lease as a direct financing lease or a leveraged lease, whichever is applicable, providing that (*a*) collection of the minimum lease payments is reasonably predictable and (*b*) no important uncertainties exist regarding costs yet to be incurred by the lessor under the lease. The land portion is accounted for separately as an operating lease.

All other leases involving land and building(s) are classified as operating leases by the lessor.

Leases Involving Land, Building(s), and Equipment

Equipment values, if material, should not be commingled with real estate values in leases. The minimum lease payments attributed to the equipment shall, if necessary, be estimated appropriately and stated separately. The criteria for the classification of leases are applied separately to the equipment to determine proper accountability (FAS-13, par. 27).

Leases Involving Only Part of a Building(s)

If the cost and fair value of a lease involving only part of a building(s) can be determined objectively, the lease classification and accountability are the same for any other land and building(s) lease. An independent appraisal of the leased property or replacement cost can be made as a basis for the objective determination of fair value (FIN-24, par. 6). In the event that cost and fair value cannot be determined objectively, leases involving only part of a building(s) are classified and accounted for as follows (FAS-13, par. 28):

Lessee

The lessee classifies the lease only in accordance with criterion (3) as follows: The lease term, at inception, is substantially (75% or more) equal to the estimated economic life of the leased property, including earlier years of use. (*Exception*: This particular criterion cannot be used for a lease that begins within the last 25% of the original estimated economic life of the leased property.)

In applying the above criterion, the estimated economic life of the building(s) in which the leased premises are located is used.

In the event the above criterion is met, the leased property is capitalized as a single unit and amortized in accordance with the lessee's normal depreciation policy over the lease term. In all other cases, the lease is classified as an operating lease.

Lessor

In all cases in which the cost and fair value are indeterminable, the lessor accounts for the lease as an operating lease.

SALE-LEASEBACK TRANSACTIONS

A sale-leaseback is a transaction in which an owner sells property and then leases back part or all of the same property. Such an owner is referred to as the seller-lessee. The purchaser-lessor is the party who purchases the property and leases back the same property to the seller-lessee. Sale-leaseback transactions involving real estate are addressed in FAS-98. All other sale-leaseback transactions are covered by FAS-28.

Non-Real Estate

Profit or loss on the sale is the amount that would have been recognized on the sale by the seller-lessee, assuming there was no leaseback (FAS-28, par. 3).

Accounting for the sale-leaseback by the seller-lessee is determined by the degree of rights in the remaining use of the property the seller-lessee retains, as follows:

1. Substantially all
2. Minor
3. More than minor but less than substantially all

Substantially All or Minor

Under the terms of the lease, the seller-lessee may have a *minor* portion or *substantially all* of the rights to the remaining use of the property. This is determined by the present value of a total *reasonable rental* for the rights to the remaining use of the property retained by the seller-lessee. The seller-lessee has transferred *substantially all* of the rights to the remaining use of the property to the purchaser-lessor if the present value of the total *reasonable rental* under the terms of the lease is 10% or less than the fair value of the property sold at the inception of the lease. The seller-lessee has transferred a *minor* portion of the remaining rights to the purchaser-lessor if the terms of the leaseback include the entire property sold and qualify as a capital lease under FAS-13 (FAS-28, par. 3a).

> **OBSERVATION:** FAS-28 does not define *reasonable rental* or *fair value*. FAS-13, however, defines *fair value* as the price the leased property could be sold for between unrelated parties in an arm's length transaction. FAS-13 defines *fair rental* as the rental rate for similar property under similar lease terms and conditions.

Whether the lease is recorded as a capital lease or an operating lease, any profit or loss (see definition) on the sale by the seller-lessee must be deferred and amortized as follows:

Capital lease For a capital lease, the deferred profit or loss on the sale is amortized in proportion to the amortization of the leased property.

Operating lease For an operating lease, the deferred profit or loss on the sale is amortized in proportion to the gross rental charged to expense over the lease term.

Whether a capital lease or an operating lease, if the leased asset is land only, the amortization of the deferred profit or loss on the sale must be on a straight-line basis over the lease term.

If the seller-lessee retains the rights to a *minor* portion of the remaining use in the property, the seller-lessee accounts for the sale and leaseback as two independent transactions based on their separate terms. The lease must provide for a reasonable amount of rent, however, considering prevailing market conditions at the inception of the lease. The seller-lessee must increase or decrease the profit or loss on the sale by an amount, if any, which brings the total rental for the leased property to a reasonable amount. Any amount created by this adjustment is amortized, as follows:

Capital lease For a capital lease, the deferred or accrued amount is amortized in proportion to the amortization of the leased property.

Operating lease For an operating lease, the deferred or accrued amount is amortized in proportion to the gross rental charged to expense over the lease term.

Whether a capital lease or an operating lease, if the leased asset is land only, the amortization of the deferred or accrued amount must be on a straight-line basis over the lease term.

> **PRACTICE POINTER:** If the total rental on the lease is less than a reasonable amount compared to prevailing market conditions at the inception of the lease, increase a profit on the sale and decrease a loss on the sale.
>
> For an operating lease, the journal entry is a debit to prepaid rent and a credit to profit or loss. Amortize the prepaid rent in an amount that increases the periodic rental expense over the lease term to a reasonable amount. Conversely, if the total rental on the lease is more than a reasonable amount compared to prevailing market conditions at the inception of the lease, decrease a profit on the sale and increase a loss on the sale. The journal entry is a debit to profit or loss and a credit to deferred rent. Amortize the deferred rent in an amount that decreases the periodic rental expense over the lease term to a reasonable amount.
>
> For a capital lease, make no debit to prepaid rent or credit to deferred rent. Instead, the debit or credit increases or decreases the amount that is recorded for the leased property. Then, amortize the leased property in the usual manner.

More Than Minor but Less Than Substantially All

If the seller-lessee retains the rights to more than minor but less than substantially all of the remaining use in the property, the seller-lessee shall recognize any excess profit (not losses) determined at the date of sale as follows (FAS-28, par. 36):

Capital lease The excess profit (if any) on a sale-leaseback transaction is equal to the amount of profit that exceeds the seller-lessee's recorded amount of the property as determined under the provisions of FAS-13 (the lesser of the fair value of the leased property or the present value of the minimum lease payments). For example, if the seller-lessee's recorded amount of the sale-leaseback property is $100,000 as determined under the provisions of FAS-13, and the amount of profit on the sale-leaseback transaction is $120,000, the excess profit that is recognized by the seller-lessee is $20,000. The balance of the profit ($100,000) is deferred and amortized in proportion to the amortization of the leased property.

Operating lease The excess profit (if any) on a sale-leaseback transaction is equal to the amount of profit that exceeds the present value

of the minimum lease payments over the term of the lease. The amount of profit on the sale-leaseback transaction that is not recognized at the date of the sale is deferred and amortized over the lease term in proportion to the gross rentals charged to expense.

Whether a capital lease or an operating lease, if the leased property is land only, the amortization of the deferred profit (if any) must be on a straight-line basis over the lease term.

Real Estate

Under the provisions of FAS-98, the definition of *sale-leaseback accounting* is analogous to the definition of the *full accrual method of accounting*. Under sale-leaseback accounting, the sale portion of a sale-leaseback transaction is recorded as a sale by the seller-lessee, the property sold and all of its related liabilities are eliminated from the seller-lessee's balance sheet, gain or loss on the sale portion of the sale-leaseback transaction is recognized by the seller-lessee in accordance with the provisions of FAS-13 (as amended by FAS-28, FAS-66, and FAS-98), and the lease portion of the sale-leaseback transaction is accounted for in accordance with the provisions of FAS-13 (as amended by FAS-28).

Under FAS-98, a seller-lessee applies sale-leaseback accounting only to those sale-leaseback transactions that include payment terms and provisions that provide for (*a*) a normal leaseback (as defined by FAS-98), (*b*) an adequate initial and continuing investment by the purchaser-lessor (as defined by FAS-66), (*c*) the transfer of all of the other risks and rewards of ownership to the purchaser-lessor, and (*d*) no other continued involvement by the seller-lessee, other than the continued involvement represented by the lease portion of the sale-leaseback transaction (FAS-98, par. 7).

Normal Leaseback

Under FAS-98, a normal leaseback is one in which the seller-lessee actively uses substantially all of the leased property in its trade or business during the lease term. The seller-lessee may sublease a minor portion of the leased property, equal to 10% or less of the reasonable rental value for the entire leased property, and the lease will still qualify as a normal leaseback. Thus, to qualify as a normal leaseback, the seller-lessee must actively use substantially all of the leased property in its trade or business in consideration for rent payments, which may include contingent rentals that are based on the seller-lessee's future operations (FAS-98, par. 8).

If occupancy by the seller-lessee's customers is transient or short-term, the seller-lessee may provide ancillary services, such as housekeeping, inventory control, entertainment, bookkeeping, and food

service. Thus, active use by a seller-lessee in its trade or business includes the use of the leased property as a hotel, bonded warehouse, parking lot, or some other similar business.

Adequate Initial and Continuing Investment by the Purchaser-Lessor

To qualify for sale-leaseback accounting under FAS-98, the purchaser-lessor's initial and continuing investment in the property must be adequate as prescribed by FAS-66 (Accounting for Sales of Real Estate) (FAS-98, par. 10). Under FAS-66, the purchaser's minimum initial investment must be made at or before the time of sale in cash or cash equivalents. A purchaser's note does not qualify for the minimum initial investment unless payment of the note is unconditionally guaranteed by an irrevocable letter of credit from an established unrelated lending institution. A permanent loan commitment by an independent third party to replace a loan made by the seller shall not be included in the purchaser's initial investment. Any funds that have been loaned or will be loaned, directly or indirectly, to the purchaser by the seller must be deducted from the purchaser's initial investment to determine whether the required minimum has been met. For the purposes of this provision, the seller must be exposed to a potential loss as a result of the funds loaned to the purchaser. For example, if a purchaser made an initial cash investment of $200,000 in a real estate transaction, $25,000 of which was a loan from the seller, the purchaser's minimum initial investment would be $175,000. If an unrelated banking institution unconditionally guaranteed the timely repayment of the $25,000 to the seller, however, the entire $200,000 would be eligible as the purchaser's initial investment. (A discussion of the detailed provisions of FAS-66 and FAS-98 are found in the 2002 *Miller GAAP Guide* chapter "Real Estate—Recognition of Sales."

Accounting for Certain Losses on Sale-Leasebacks

Under any circumstances, if the fair value of the property at the time of the sale-leaseback is less than its undepreciated cost, the seller-lessee recognizes immediately a loss in an amount not to exceed the difference between the fair value and the undepreciated cost of the property sold (FAS-28, par. 3c).

> **OBSERVATION:** Paragraph 33c of FAS-13, as amended by paragraph 3 of FAS-28, states that the maximum indicated loss may not be more than the difference between the undepreciated cost of the property sold and its fair value. On the other hand, paragraph 18 of FAS-28 states that the maximum indicated loss may not be more than the difference between the carrying

amount of the property sold and its fair value. Thus, it is not clear whether the undepreciated cost or the carrying amount of the property should be used in calculating the maximum loss that is recognized immediately.

OTHER LEASE ACCOUNTING ISSUES

Wrap Lease Transactions

In a wrap lease transaction, a lessor leases equipment to a lessee and obtains nonrecourse financing from a financial institution using the lease receivable and the asset as collateral. The lessor sells the asset subject to the lease and the nonrecourse financing to a third-party investor and then leases the asset back. Thus, the original lessor remains the principal lessor, who continues to service the lease. The transaction with the third-party investor may or may not occur at the same time that the original lease is executed with the original equipment user. As a matter of fact, it is not unusual in a wrap lease transaction for the subsequent nonrecourse financing or sale to a third party to occur up to six months after the original lease agreement is executed.

In exchange for the sale of the asset to a third-party investor, the lessor may receive a combination of cash, a note, an interest in the residual value of the leased asset, and certain other rights or contingent rights, such as the right to remarket the asset at the end of the lease term. Depending on the terms of the specific transaction, (*a*) the lessor may or may not be liable for the leaseback payments if the primary lessee defaults, (*b*) the lessor may or may not receive a fee for servicing the lease, (*c*) payments under the leaseback may or may not approximate collections under the note, and (*d*) the terms of the leaseback may or may not correspond with the terms of the original equipment lease.

A wrap lease transaction consists primarily of a sale-leaseback of property and is accounted for as such under FAS-13 or FAS-98, whichever is applicable. If the property involved in a wrap lease transaction is other than real estate, the provisions of FAS-13, as amended by FAS-28, must be followed. On the other hand, if the property involved is real estate, the provisions of FAS-98 must be observed in accounting for the sale-leaseback transaction.

Under sale-leaseback accounting, the sale portion of a sale-leaseback transaction is recorded as a sale by the seller-lessee. The property sold and all of its related liabilities are eliminated from the seller-lessee's balance sheet. Gain or loss on the sale portion of the sale-leaseback transaction is recognized by the seller-lessee in accordance with paragraph 33 of FAS-13, as amended by FAS-28. The lease portion of the sale-leaseback transaction should be classified as a capital lease or an operating lease in accordance with paragraph 6 of FAS-13 and accounted for by the seller-lessee in accordance with paragraph 33 of FAS-13 (FAS-28, par. 3).

The purchaser-lessor records a sale-leaseback transaction as a purchase and a direct financing lease if the lease portion of the sale-leaseback meets the criteria of a capital lease under FAS-13. Otherwise, the purchaser-lessor records the transaction as a purchase and an operating lease (FAS-13, par. 34).

The main difference in accounting for a sale-leaseback under FAS-13 and FAS-98 is that under the provisions of FAS-98, the sale portion of the sale-leaseback must meet all of the criteria for sales recognition under the provisions of FAS-66. FAS-98 prohibits a lease involving real estate from being classified as a sales-type lease unless the lease agreement provides for the title of the leased property to be transferred to the lessee at or shortly after the end of the lease term.

In reporting a wrap lease transaction, an enterprise's statement of financial position should include (*a*) the amount of the retained residual interest in the leased property, (*b*) the amount of the gross sublease receivable, (*c*) the amount of the nonrecourse third-party debt, (*d*) the amount of the leaseback obligation, and (*e*) the amount of the note receivable from the investor.

Illustration of Wrap Lease Transactions

Assume that a lessor leases an asset with an undepreciated cost of $1,000 to a lessee for five years at $19.12 a month. The residual value of the leased asset at the end of the lease term is estimated to be $164.53 and the interest rate implicit in the lease is 10%. The lessor would classify the lease as a direct financing lease under the provisions of FAS-13 and record the following journal entry:

Lease receivable (60 x $19.12)	$1,147.20	
Residual value of leased asset	164.53	
Asset		$1,000.00
Unearned income—lease receivable		247.20
Unearned income—residual		64.53

Note: For financial reporting purposes, FAS-13 requires that the lease receivable and residual value of the leased asset be combined and reported as the gross investment in the lease. In addition, the unearned income amounts must also be combined.

Using the lease receivable and the asset as collateral, the lessor enters into a nonrecourse financing arrangement with a financial institution for $900.00 (the present value of the $19.12 monthly lease payment for 60 months discounted at 10%) at a rate of 10%. The lessor would record the following journal entry to reflect the liability for the nonrecourse debt:

Cash	$900.00	
Nonrecourse debt		$900.00

The lessor then sells the asset subject to the lease and the nonrecourse debt to a group of equity partners and leases the asset back for five years at $19.12 a month (for simplicity, assume that the lease, the nonrecourse financing, and the sale to the equity partners occur at the same time). The lessor is now the lessee-sublessor and remains the obligor with the financial institution that financed the nonrecourse debt. In return for the asset, the lessor receives the following:

1. Cash of $50, representing the sale of 50% of the residual value of the leased asset
2. An additional $103.66 in cash, representing the transfer of tax benefits [for purposes of this illustration, the $103.66 represents the discounted tax benefits associated with the transaction using 1985 tax laws, and includes the investment tax credit (ITC)]
3. A note receivable for $900.00 bearing interest at 10% with 60 monthly payments of $19.12 (60 payments at $19.12 represent a gross note of $1,147.20 and unearned income of $247.20)
4. The right to receive a fee of $82.27 for remarketing the asset at the end of the initial lease term (the present value of an $82.27 payment 60 months in the future discounted at 10% equals $50.00)
5. In addition, the lessor retains a 50% interest in the proceeds of the residual value of the leased asset at the end of the lease term

Subleases and Similar Transactions

Unless the original lease agreement is replaced by a new agreement, the original lessor continues to account for the lease as before (FAS-13, par. 36).

A termination of a lease is recognized by a lessor in the income of the period in which termination occurs, as follows (FAS-13, par. 37):

1. The remaining net investment is eliminated from the accounts.
2. The leased property is recorded as an asset using the lower of the (*a*) original cost, (*b*) present value at termination, or (*c*) present carrying amount at termination.

If an original lessee is relieved of the primary obligation under an original lease, the transaction is accounted for by the lessee as follows (FAS-13, par. 38):

- **Capital leases**—Termination of the lease occurs and gain or loss is recognized in income of the period. A loss contingency should also be provided for if the original lessee remains secondarily liable on the lease.
- **Operating leases**—A loss contingency is provided for if the original lessee remains secondarily liable on the lease.

When a lessee subleases leased property, the original lease continues and a simultaneous new lease is created in which the lessee becomes a sublessor. The results are that the original lessee is both a lessee in the original lease and, at the same time, a sublessor in the new lease. In situations like this, the original lease continues to be accounted for as if nothing happened, but the new lease is classified and accounted for separately.

If an original lessee is not relieved of the primary obligation under an original lease, the transaction is accounted for by the original lessee-sublessor as follows (FAS-13, par. 39):

1. If the criterion for the original lease was criterion (1) (ownership of the property is transferred before the end of the lease term) or (2) (lease contains a bargain purchase option), the new lease is classified based on its own new criteria. If the new lease qualifies for capitalization, it is accounted for as a sales-type or a direct financing lease, whichever is appropriate, and the unamortized balance of the asset under the original lease is treated as the cost of the leased property to the sublessor (original lessee).

   In the event that the new lease does not qualify for capitalization, it is treated as an operating lease.
2. If the criterion for the original lease was criterion (3) (lease term is substantially—75% or more—equal to the estimated economic life of the leased property at the inception of the lease) or (4) (present value of the minimum lease payments—excluding executory costs—is 90% or more of the fair value at inception), the new lease is capitalized only if it meets criterion (3) and (*a*) the collection of the minimum lease payments is reasonably predictable and (*b*) no important uncertainties exist regarding costs yet to be incurred by the lessor under the lease. If the new lease meets the criteria above, it is accounted for as a direct financing lease, with the amortized balance of the asset under the original lease as the cost of the leased property.

   If the new lease does not meet the specific conditions above, it is accounted for as an operating lease.

In any event, if the original lease is an operating lease, the sublease also is accounted for as an operating lease (FAS-13, par. 39c).

Even though the sublessor (original lessee) remains primarily obligated under an original lease, a loss may be recognized on a sublease. The loss is measured as the difference between the unamortized cost of the leased property (net carrying amount) and the present value of the minimum lease payments which will be received under the terms of the sublease (FIN-27, par. 2).

> **OBSERVATION:** FIN-27 is silent as to recognition of any gain on subleases in which the sublessor (original lessee) remains primarily obligated under the original lease. FAS-13, paragraph 39, however, implies that **both** gain and loss may be recognized on sales-type and direct financing leases.

FIN-27 also reaffirms that estimated costs and expenses directly associated with a decision to dispose of a business segment should include future rental payments on long-term leases less any future rentals to be received from subleases of the same properties (APB-30, par. 17). The gain or loss is measured as the difference between the unamortized cost of the leased property (net carrying amount) and the present value of the minimum lease payments that will be received under the terms of the sublease. The gain or loss is included in the overall gain or loss on the disposal of the business segment (FIN-27, par. 3).

> **OBSERVATION:** FIN-27 is not clear on its coverage of subleases that are classified as operating leases. There is a strong argument that gain or loss on an operating sublease be included as part of the overall gain or loss on disposal of a business segment. APB-30 specifically states that all costs and expenses that are directly associated with the decision to dispose of a business segment be included in the overall gain or loss on the disposal. If a business segment has a long-term operating lease that is subleased and classified as an operating lease as part of the overall disposal of the segment, then any gain or loss would be associated directly with management's decision to dispose of the segment. The gain or loss would be measured as the difference between the present value of the future rental payments that must be paid on the original lease and the present value of the future rental receipts that will be collected on the operating sublease. The journal entry to record a loss would be a debit to the gain or loss account for disposal of the business segment and a credit to a deferred account. The deferred credit account would be amortized each year in an amount that would make up the difference between the payment made on the original lease and the rental collected on the operating sublease.

Leases Involving Governmental Units

Leases with governmental units usually lack fair values, have indeterminable economic lives, and cannot provide for transfer of ownership.

These special provisions usually prevent their classification as any other than operating leases (FAS-13, par. 28).

Leases involving governmental units, however, are subject to the same criteria as any other lease unless all of the following conditions exist; and in that event, these leases are classified as operating leases (FIN-23, par. 8):

1. A governmental unit or authority owns the leased property.
2. The leased property is operated by or on behalf of a governmental unit or authority and is part of a larger facility, such as an airport.
3. The leased property cannot be moved to another location because it is a permanent structure or part of a permanent structure.
4. Any governmental unit or authority can terminate the lease agreement at any time under the terms of the lease agreement, existing statutes, or regulations.
5. Ownership is not transferred to the lessee and the lessee cannot purchase the leased property.
6. Equivalent property in the same area as the leased property cannot be purchased or leased from anyone else.

Related Party Leases

Except in cases in which the substance of a lease transaction indicates clearly that the terms and conditions have been significantly influenced by the related parties, related party leases are classified and accounted for as if the parties were unrelated (FAS-13, par. 29).

It is important to note that, generally, a subsidiary whose principal business activity is leasing property to its parent must be consolidated with the parent's financial statements (FAS-13, par. 31).

> **OBSERVATION:** Specific financial statement disclosures pertaining to related parties are required by FAS-57 (Related Party Disclosures).

Leveraged Leases

A lessee classifies and accounts for *leveraged* leases in the same manner as *nonleveraged* leases. *Only a lessor* must classify and account for leveraged leases in the specific manner prescribed herein (FAS-13, par. 41).

FAS-13 defines a *leveraged lease* as a lease having all the following characteristics (FAS-13, par. 42):

1. A leveraged lease meets the definition of a *direct financing lease* as follows:

   A direct financing lease is a lease that does not result in a manufacturer's or dealer's profit or loss because the fair value of the leased property at the inception of the lease is the same as the cost or carrying amount. In a direct financing lease, substantially all the benefits and risks inherent in the ownership of the lease property are transferred to the lessee. In addition, the following requirements must be met:

   a. The minimum lease payments are reasonably predictable of collection.

   b. No important uncertainties exist regarding costs to be incurred by the lessor under the terms of the lease.

2. It involves at least three parties: (*a*) a lessee, (*b*) a lessor, and (*c*) a long-term creditor. (**Note:** The lessor is sometimes referred to as the *equity participant.*)

3. The financing is sufficient to provide the lessor with substantial leverage in the transaction and is nonrecourse as to the general credit of the lessor.

4. Once the lessor's net investment is completed, it declines in the early years and rises in later years before being liquidated. These fluctuations in the lessor's net investment can occur more than once in the lease term.

☛ **PRACTICE POINTER:** Leveraged leases are complex contracts that meet very specific criteria. Accounting for leveraged leases is unique in certain ways (e.g., offsetting assets and liabilities) and, therefore, determining whether a given lease is a leveraged lease is particularly important. A lease must meet *all* of the following specific criteria (taken from the definition of a leveraged lease) to be accounted for as a leveraged lease:

1. The lease is a direct financing lease.
2. The lease involves three parties rather than the normal two.
3. The lease provides the lessor with substantial leverage.
4. The pattern of the lessor's investment declines then rises.

Only when all four of these conditions are met is the lease subject to leveraged lease accounting.

If the investment tax credit is accounted for as provided herein and a lease meets the preceding definition, it is classified and accounted for as a leveraged lease (FAS-13, par. 42).

The initial and continuing investment of the lessor in a leveraged lease is recorded *net* of the nonrecourse debt, as follows (FAS-13, par. 43):

1. Rentals receivable, net of that portion applicable to principal and interest on the nonrecourse debt
2. A receivable for the amount of the investment tax credit to be realized on the transaction
3. The estimated residual value of the leased property
4. Unearned and deferred income consisting of (*a*) the estimated pretax lease income or loss, after deducting initial direct costs of negotiating and consummating the lease transaction, that remains to be allocated to income over the lease term and (*b*) the investment tax credit that remains to be allocated to income over the lease term

The investment in a leveraged lease, less applicable deferred taxes, represents the lessor's net investment for purposes of computing periodic net income from the leveraged lease (FAS-13, par. 43). The following method is used to compute periodic net income (FAS-13, par. 44):

1. A projected cash flow analysis is prepared for the lease term.
2. The rate of return on net investment in the years it is positive is computed (usually by trial and error).
3. Every year the net investment is increased or decreased by the difference between the net cash flow and the amount of income recognized, if any.

The amount of net income that is recognized each year consists of (FAS-13, par. 44):

1. Pretax lease income or loss (allocated from the unearned income portion of the net investment)
2. Investment tax credit (allocated from the deferred income portion of the net investment)
3. The tax effect of the pretax lease income or loss recognized (which is reflected in tax expense for the year)

Any tax effect on the difference between pretax accounting income or loss and taxable income or loss is charged or credited to deferred taxes.

All the important assumptions affecting the estimated net income from the leveraged lease, including any estimated residual values, should be reviewed at least annually.

If, at the inception or at any time during the lease, the projected net cash receipts over the initial or remaining lease term are less than the lessor's initial or current investment, the resulting loss is immediately recognized (FAS-13, par. 45).

Upward adjustments of the estimated residual value are not permitted (FAS-13, par. 46).

The lessor's financial statement disclosure for leveraged leases shall include the amount of deferred taxes stated separately. When leveraged leasing is a significant part of the lessor's business activity, a schedule of the components of the net investment in leveraged leases shall be disclosed fully in the footnotes to the financial statements (FAS-13, par. 47).

Lessor's Existing Asset in a Leveraged Lease

Only a direct financing lease may qualify as a leveraged lease (FAS-13, par. 42a). One of the requirements of a direct financing lease is that it may not result in a manufacturer's or dealer's profit or loss. It is difficult for an existing asset of a lessor to qualify for leveraged lease accounting because the carrying amount (cost less accumulated depreciation) of an asset previously placed in service is not likely to be the same as its fair value. An existing asset of a lessor may qualify for leveraged lease accounting, however, if its carrying amount is equal to its fair value, without any write-down or other adjustment to its fair value.

Business Combinations

A business combination, in itself (FIN-21, pars. 13–14), does not affect the classification of a lease. If as a result of a business combination, however, a lease is revised or modified to the extent that under FAS-13 it is considered a new agreement, it is reclassified based on its revision or modification.

Ordinarily, under the purchase method or pooling-of-interests method of effecting a business combination, a lease retains its previous classification under FAS-13 and is accounted for in the same manner as it was prior to the combination.

The acquiring company in a business combination accounted for by the purchase method accounts for a leveraged lease by assigning a fair value (present value, net of tax) to the net investment in a leveraged lease based on the remaining future cash flows with appropriate recognition for any future estimated tax effects. After the fair value (present value, net of tax) of the net investment is determined, it is allocated to net rentals receivable, estimated residual value, and unearned income. Thereafter, a company accounts for the leveraged lease by allocating the periodic cash flow between the net investment and the lease income (FIN-21, par. 16).

In a business combination in which an acquired lease has not been conformed to FAS-13, the acquiring company classifies such a lease to conform retroactively to FAS-13 (FIN-21, par. 17).

RELATED 2002 *MILLER GAAP GUIDE* CHAPTERS

- Chapter 4, "Business Combinations"
- Chapter 8, "Consolidated Financial Statements"
- Chapter 16, "Extinguishment of Debt"
- Chapter 31, "Long-Term Obligations"
- Chapter 38, "Real Estate Transactions"
- Chapter 39, "Related Party Disclosures"