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Accounting for lease transactions by manufacturer or dealer lessors; Opinions of the Accounting Principles Board 27; APB Opinion 27

American Institute of Certified Public Accountants. Accounting Principles Board

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*Accounting for Lease Transactions
by Manufacturer or Dealer Lessors*

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*Issued by the Accounting Principles Board of the
American Institute of Certified Public Accountants*

INTRODUCTION

1. The accounting for leases entered into with independent lessees by manufacturers or dealers to assist in marketing their products or services is generally covered by APB Opinion No. 7, *Accounting for Leases in Financial Statements of Lessors*. However, the interpretation and application in practice of the Opinion have raised a number of questions since its issuance in May 1966.

DISCUSSION

2. Questions have arisen about the circumstances under which it is appropriate to conclude that the manufacturer or dealer lessor has transferred the risks and rewards of ownership to the lessee thus allowing the lessor to record the lease transaction as if it were a sale of the leased property. In some cases, a sale has been recognized where a manufacturer or dealer lessor delivered property under a cancelable lease or under a non-cancelable lease for only a portion of the economic life¹ of the property. Sometimes it was assumed that a cancelable lease would not be canceled or that a noncancelable lease for a period shorter than the economic life would be subsequently renewed. Determining these probabilities has proven to be extremely difficult in many cases. Assumptions that the lessee would continue to lease the property even though not legally obligated to do so sometimes were not realized in practice. Further, in some cases, a manufacturer or dealer sold or assigned a lease, or property subject to a lease, to an independent financing institution with certain guarantees by the manufacturer or dealer, raising questions as to the accounting for the sale or assignment. Likewise, a manufacturer or dealer sold property to an independent financing institution which leased the property to others with certain guarantees by the manufacturer or dealer, creating complications in accounting for the transaction. Additional problems arise if these transactions are with a related entity rather than with an independent entity.

¹ The term *economic life*, as used in this Opinion, refers to the period during which the property is generally expected to be used for the purpose for which it was designed. Economic life is usually shorter than the physical life of the property. Also, economic life can cover a period of use by more than one user and is therefore not dependent upon the operating policies of any particular user.

3. The Board has concluded that more specific criteria are needed to determine when a manufacturer or dealer lessor should recognize a lease transaction with an independent lessee as if it were a sale. This Opinion supersedes the last sentence of paragraph 8 and all of paragraph 12 of APB Opinion No. 7. Except as stated in the preceding sentence, this Opinion does not modify APB Opinion No. 7. Because of the highly specialized problems involved, this Opinion does not apply to lease agreements concerning real estate and natural resources such as oil, gas, timber, and mineral rights. It also does not apply to the accounting for lease financing transactions by independent financing institutions and independent leasing companies. The Opinion is, however, applicable to these organizations if they are acting as dealers.

OPINION

Two-party lease transactions

4. *Leases equivalent to sales.* Some lease transactions with independent lessees are in substance equivalent to sales of the property with the sales price collectible over a period of time. A manufacturer or dealer lessor should account for a lease transaction with an independent lessee as a sale if at the time of entering into the transaction (a) collectibility of the payments required from the lessee is reasonably assured, (b) no important uncertainties, such as those described in paragraph 7, surround the amount of costs yet to be incurred² under the lease, and (c) any one of the following conditions is present:

- (i) The lease transfers title to the property to the lessee by the end of its fixed, noncancelable term; or
- (ii) The lease gives the lessee the option to obtain title to the property without cost or at a nominal cost by the end of the fixed, noncancelable term of the lease; or

² Maintenance, management or service agreements, either separate from or as a part of the lease agreement, do not preclude recording the lease transaction as a sale if the agreements provide the manufacturer or dealer with a reasonable return on the services rendered under such agreements. If the revenues from such agreements are included as part of the lease payments, these revenues should not be considered as part of the sales price of the property.

- (iii) The leased property, or like property, is available for sale, and the sum of (1) the present value³ of the required rental payments⁴ by the lessee under the lease during the fixed, noncancelable term of the lease (excluding any renewal or other option) and (2) any related investment tax credit retained by the lessor (if realization of such credit is assured beyond any reasonable doubt) is equal to or greater than the normal selling price or, in the absence thereof, the fair value (either of which may be less than cost) of the leased property or like property;⁵ or
- (iv) The fixed, noncancelable term of the lease (excluding any renewal option) is substantially equal to the remaining economic life⁶ of the property. (This test cannot be complied with (1) by estimating an economic life substantially equal to the noncancelable term if this is unrealistic or (2) if a material contingent residual interest is retained in the property.)

5. A high credit risk frequently presents measurement problems (a) in determining the interest rate that is commensurate with the risk and should be applied in computing the present value of the rental payments or (b) in determining an adequate provision for bad debts. When the credit risk is so high as to preclude reasonable assurance of collection the lease transaction should not be recorded as a sale.

6. When a lease transaction by a manufacturer or dealer lessor is recorded as a sale, (a) revenue should be recognized in the period of the sale in an amount equal to the present value of the required rental payments⁷ by the lessee under the lease during the fixed, noncancelable term (excluding any renewal or other option) of the lease and (b) the cost of the property

³ See APB Opinion No. 21, *Interest on Receivables and Payables*, paragraphs 13 and 14.

⁴ Maintenance, management and service charges should be excluded from rental payments for purposes of this computation. See footnote 2.

⁵ In making the determination under (iii) no consideration should be given to the residual or salvage value. Residual or salvage value should be disregarded in determining whether a lease transaction should be treated as a sale because recognition of a sale implies that the revenue has been earned and all costs have been incurred or provided for at the time.

⁶ See footnote 1.

⁷ See footnotes 2 and 4.

(not reduced by salvage or residual value) and the estimated related future costs⁸ (other than interest) should be charged against income in that period.⁹ In some cases this may result in a loss on the transaction.

7. *Operating leases.* Important uncertainties may still exist in some lease transactions that otherwise appear to meet the tests for recognition as a sale (see paragraph 4). For example, the lease may contain commitments by the lessor to guarantee performance in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence. The difficulties of evaluating the future costs, both individually and collectively, and thus the risks under such commitments may be so great that the lease transaction should be accounted for by the operating method.

8. A manufacturer or dealer lessor should account for a two-party lease transaction that does not meet the criteria described in paragraph 4 for treatment as a sale by use of the operating method as set forth in APB Opinion No. 7.

9. An implicit loss exists and should be recognized by the manufacturer or dealer whenever the rental payments expected to be received from independent lessees over the remaining economic life¹⁰ of the leased property together with its estimated residual value are insufficient to recover the unrecovered costs pertaining to the property, estimated related future costs and any deferred costs relating to leases of the property.

Participation by third parties

10. In some instances a manufacturer or dealer lessor sells or assigns a lease, or property subject to a lease, to independent

⁸ In paragraph 4 of APB Opinion No. 21, *Interest on Receivables and Payables*, the Board stated that it was "not taking a position as to the application of the present value measurement (valuation) technique to estimates of contractual or other obligations assumed in connection with sales of property, goods, or service, for example, a warranty for product performance." Inasmuch as the revenue from a lease transaction recorded as a sale is measured by the present value of the required rental payments under the lease, the Board has concluded that estimates of future costs related to the lease may also be measured on the present value basis.

⁹ In determining the amount of profit or loss to be recognized on the transaction consideration should be given to any related investment tax credits.

¹⁰ See footnote 1.

financing institutions and independent leasing companies. In other instances, a manufacturer or dealer sells the property to the financing institutions and at that time a lease for the property is obtained for the benefit of the institutions. In these cases, a third party is participating in a lease transaction involving a manufacturer or dealer and the lessee. The terms of the underlying leases and the risks and rewards retained by the manufacturers or dealers should determine the accounting for such transactions by the manufacturers or dealers.

11. *Leases equivalent to sales.* The sale or assignment by a manufacturer or dealer to an independent financing institution of a lease, or of property subject to a lease, that meets, insofar as the lease transaction is concerned, the conditions of paragraph 4 does not negate the original determination that the lease transaction should be accounted for as a sale. Profit or loss, if any, on the transaction with the financing institution should be recognized at the time of sale or assignment to the financing institution.

12. *Operating leases.* The sale to an independent financing institution of property subject to an operating lease, or of property which is leased by or intended to be leased by the financing institution to an independent party, with the manufacturer or dealer effectively retaining any risks of ownership in the property, is not a sale in substance and, therefore, should not be accounted for as a sale. However, the sale to an independent financing institution of such property should be reflected as a sale if no important uncertainties such as those described in paragraph 7 exist and either (a) all risks and rewards of ownership in the property are transferred to the purchaser or (b) all risks are transferred but some of the rewards are retained by the manufacturer or dealer and the sum of the present value of the required payments¹¹ by the purchaser and any related investment tax credit retained by the dealer (see paragraph 4(c)(iii)) is equal to or greater than the normal selling price or, in the absence thereof, the fair value of the property. When a sale is recorded, all costs should be charged against income in that period (see paragraph 6).

¹¹ See footnotes 2 and 4.

13. A manufacturer or dealer may by various arrangements assure recovery of the investment by the third-party financing institution in some operating lease transactions and thus retain substantial risks of ownership in the property. For example, in the case of default by the lessee or termination of the lease, the arrangements may involve a formal or informal commitment by the manufacturer or dealer (a) to acquire the lease or the property, (b) to substitute an existing lease, or (c) to secure a replacement lessee or a buyer for the property under a remarketing agreement. In these circumstances the manufacturer or dealer has not transferred all risks and should not reflect the transaction as a sale. However, a remarketing agreement by itself should not disqualify accounting for the transaction as a sale if the manufacturer or dealer (a) will receive a reasonable fee, commensurate with the effort involved, at the time of securing a replacement lessee or buyer for the property and (b) is not required to give any priority to the re-leasing or disposition of the property owned by the third party over similar property owned or produced by the manufacturer or dealer. (For example, for this purpose, a "best efforts" or a first-in, first-out, remarketing arrangement is considered to be a priority.)

14. When the sale to an independent financing institution of property subject to an operating lease is not reflected as a sale, the transaction should be accounted for as a loan and revenue should be recognized under the operating method. Likewise, the sale or assignment by a manufacturer or dealer of lease payments due under an operating lease should continue to be accounted for under the operating method by the manufacturer or dealer and the proceeds should be recorded as a loan. (Transactions of these types are in effect collateralized loans from the financing institution to the manufacturer or dealer.)¹² However, if all risks of ownership in the property are transferred but the transaction does not qualify as a sale because the sum of the present value of the required payments¹³ by the purchaser and any related investment tax credit retained by the dealer (see paragraph 4(c)(iii)) is less than the normal selling price or,

¹² Also see paragraph 9 of this Opinion with regard to recognition of an implicit loss under an operating lease.

¹³ See footnotes 2 and 4.

in the absence thereof, the fair value of the property (see paragraph 12), the proceeds should be classified as deferred revenue and taken into income under the operating method.¹⁴

Transactions with Related Companies

15. *Leases equivalent to sales.* The sale or assignment by a manufacturer or dealer to a related company¹⁵ of a lease, or property subject to a lease, that meets, insofar as the lease transaction is concerned, the conditions of paragraph 4 does not negate the original determination that the lease transaction should be accounted for as a sale. Profit or loss, if any, on the transaction with the related company should be recognized following the principles of ARB No. 51, *Consolidated Financial Statements*, or APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, whichever is appropriate.

16. *Operating leases.* The sale to a related company of property (or an undivided interest in the property) subject to an operating lease, or of property (or an undivided interest in the property) which is leased by or intended to be leased by the related company to an independent party, is not a sale in substance if the manufacturer or dealer retains any risks of ownership in the property and, therefore, should not be accounted for as a sale. Likewise, the sale or assignment to a related company of lease payments due under an operating lease should continue to be accounted for under the operating method by the manufacturer or dealer. Further, the lease of property to a related company should not be considered a sale by the manufacturer or dealer unless the related company has leased the property to an independent lessee in a transaction that meets the

¹⁴ Also see paragraph 9 of this Opinion with regard to recognition of an implicit loss under an operating lease.

¹⁵ For the purposes of this section (paragraphs 15 and 16) of this Opinion a related company is considered to be a subsidiary, corporate joint venture, partnership, unincorporated joint venture or other investee in which the manufacturer or dealer has a financial interest. Financial interest refers to those situations in which the manufacturer or dealer directly or indirectly controls the related company or has the ability to exercise significant influence over operating and financial policies of the related company. (See Opinion No. 18, paragraph 17.) Significant influence may be exercised through guarantees of indebtedness, extension of credit and other special arrangements, or ownership of warrants, debt obligations or other securities.

conditions of paragraph 4 of this Opinion and the manufacturer or dealer retains no risks of ownership in the property. When a sale is recorded by the manufacturer or dealer, all costs should be charged against income in that period (see paragraph 6). Profit or loss, if any, on the transaction with the related company should be recognized following the principles of ARB No. 51 or APB Opinion No. 18, whichever is appropriate.¹⁶

17. The sale by a manufacturer or dealer to an unrelated company of an undivided interest in property subject to an operating lease, or of an undivided interest in property which is leased by or intended to be leased by the unrelated company to an independent party, creates a situation similar to a joint venture and therefore should not be accounted for as a sale unless the transaction meets the conditions of paragraph 4 of this Opinion and the manufacturer or dealer retains no risks of ownership in the property. When a sale of an undivided interest is recorded by the manufacturer or dealer, all costs pertaining to that undivided interest should be charged against income in that period (see paragraph 6).

EFFECTIVE DATE

18. The provisions of this Opinion shall be effective for all lease transactions involving manufacturers or dealers with independent lessees after December 31, 1972. However, the accounting for lease transactions that have previously been entered into in the fiscal year in which December 31, 1972 occurs may be adjusted to comply with the provisions of this Opinion.

The Opinion entitled "Accounting for Lease Transactions by Manufacturer or Dealer Lessors" was adopted by the assenting votes of sixteen members of the Board, of whom four, Messrs. Cummings, Ferst, Hampton, and Watt, assented with qualification. Messrs. Halvorson and Hayes dissented.

Messrs. Cummings and Ferst assent to the publication of this Opinion but disagree with the conclusions expressed in paragraphs 16 and 17 because in their view the conclusions are in-

¹⁶ Also see paragraph 9 of this Opinion with regard to recognition of an implicit loss under an operating lease.

consistent with accepted accounting principles generally applicable to sales of interests in property and are in conflict with the principle set forth in paragraph 10, that the "risks and rewards retained by the manufacturers or dealers should determine the accounting for such transactions." They believe that if the portion of the risks and rewards transferred are commensurate with the proportionate interest in the property sold by the manufacturer or dealer, the sale to a noncontrolled party of an interest in property, whether or not it is or may be subject to a lease, should be recognized together with the related profit with appropriate elimination of profit in proportion to the seller's financial interest, if any, in the buyer.

Mr. Hampton qualifies his assent because he disagrees with the conclusions of paragraph 17 because they conflict with generally accepted principles of accounting for sales of undivided interests in property generally. He believes that the existence or nonexistence of arrangements (and, a *fortiori*, of "intent") to lease property is wholly irrelevant to the issue of recording revenue, costs, and profit (or loss) in a consummated sale of an undivided interest in that property to an unrelated buyer to whom the seller has no further obligations. In his view, paragraph 17 is clearly inconsistent with the concept in paragraph 10 that "risks and rewards retained by the manufacturers or dealers should determine the accounting for such transactions;" he agrees with that concept and points out that, with respect to an undivided interest sold without any further obligations to the buyer, the seller's risks and rewards are precisely nil.

Mr. Watt assents to the issuance of this Opinion because he believes that for the most part it clarifies APB Opinion No. 7. However, he believes that only leases whose fixed, noncancellable term is substantially equal to the remaining economic life of property should be accounted for as a sale. Accordingly, he does not concur with the condition established in paragraph 4(c)(iii) which requires a lease to be accounted for as a sale when the discounted rental payments equal or exceed the normal selling price if the property is leased for only a portion of its remaining economic life (i.e., only a portion of the property rights have been transferred to the lessee). This provision requires the recording of a sale (and the omission from the balance sheet of a

valuable property right) when there is a reasonable expectation of future additional revenue (a second "sale" or lease revenue) arising from the estimated remaining economic life of the property after the expiration of the lease. He believes that a "sale" should be reported only when the lease represents the disposition of substantially all of the economic value of the property.

Mr. Hayes dissents to the issuance of this Opinion because he believes that it does not establish sound or logical accounting principles governing the sale of property subject to an operating lease. He disagrees with the conclusion in paragraphs 12 and 14 that any retention of risk of ownership in leased property sold by a manufacturer or dealer makes the sale a loan. He believes that application of such a criterion would in many instances require lessors to report fictitious liabilities and cause the leased property to appear as an asset in the balance sheets of both the buyer and the seller. In his view, leased property should ordinarily be shown as an asset of the entity possessing the preponderance of the rewards of ownership of the property. Risks retained by the seller should be recognized either by providing for costs to be incurred in the future or, if they are not subject to reasonable estimation, by deferring some or all of the profit. He disagrees with the conclusion in paragraph 12 that in order for a sale (in form) of property subject to an operating lease to be accounted for as a sale where the seller retains some rewards of ownership the seller must obtain the "normal selling price." In his view, a sale should be recognized as such even though the seller retains an interest in the property and therefore transfers the property at a price less than the price at which the entire interest in the property would be sold. He disagrees with the implication in paragraph 13 that remarketing arrangements of the types known as "best efforts" or "first-in, first-out" assign to the leased property owned by a third-party financing institution a type of remarketing priority which assures recovery of the investment by the financing institution and that they cause the sale by the manufacturer or dealer to become a liability to the financing institution.

Mr. Hayes also disagrees with the conclusions of paragraph 17 for the reasons expressed in the qualified assent of Mr. Hampton.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosure of Departures From Opinions of the Accounting Principles Board, October 1964). Members of the Institute must assume the burden of justifying any such departures.

Accounting Principles Board (1972)

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