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MAY 1966

OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD

7

Accounting for Leases in Financial Statements of Lessors

INTRODUCTION

1. This Opinion sets forth the Board's views as to accounting for the revenue and expense related to, and the investment in, property leased to others. Because of the highly specialized problems involved, this Opinion does not apply to lease agreements concerning natural resources such as oil, gas, timber and mineral rights.

2. The principal accounting problems of lessors concern the allocation of revenue and expense to the accounting periods covered by a lease. Although the lease typically establishes a schedule of rent to be received by the lessor, the treatment of this rent as revenue in the period of receipt does not necessarily result in a fair measurement of the lessor's periodic income during the term of the lease. The allocation to accounting periods of acquisition and operating costs of the leased property and of costs of negotiating and closing the lease needs to be systematic, rational, and consistent with the method of recognizing revenue. The description and classification in the balance sheet of the investment in leasing activities is also of importance.

DISCUSSION

Leasing activities

3. Lessors may engage in leasing activities to accomplish one or more objectives, such as: investing funds; facilitating the

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sale or use of the lessor's own manufactured product; retaining control of locations when it is desirable that the property be operated by others; and making available to others property operated by the lessor for profit. Some lessors engage in leasing primarily or solely as a method of investing funds; some financing institutions specialize in leasing. On the other hand, some lessors engage in leasing as incidental to entirely different and relatively more significant business operations. Leasing activities of many lessors have both financing and operating characteristics to some degree, and some lessors have leasing activities of both types.[1]

Accounting methods

4. There are two predominant methods in general use for allocating rental revenue and expenses over the accounting periods covered by a lease. These may be termed the "financing" and the "operating" methods.

5. *Financing method* – Under the financing method, the excess of aggregate rentals over the cost (reduced by estimated residual value at the termination of the lease) of the leased property is generally designed to compensate the lessor for the use of the funds invested. Since this excess is in the nature of interest, it is recognized as revenue during the term of the lease in decreasing amounts related to the declining balance of the unrecovered investment or, in other words, as an approximately level rate of return on funds not yet recovered. When rentals are level, this results in a decreasing percentage of each succeeding rental being accounted for as revenue and an increasing percentage as recovery of investment. This is comparable to the method followed by most lending institutions in accounting for level repayment plans.

6. *Operating method* – Under the operating method, aggregate rentals are reported as revenue over the life of the lease.

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[1] A comprehensive discussion of leasing will be found in Accounting Research Study No. 4, *Reporting of Leases in Financial Statements* by John H. Myers, published by the American Institute of Certified Public Accountants in 1962. (Accounting research studies are not statements of this Board or of the Institute, but are published for the purpose of stimulating discussion on important accounting issues.)

The amount of revenue to be recognized in each accounting period will ordinarily be equivalent to the amount of rent receivable according to the provisions of the lease unless distortion of periodic revenue would result, e.g., when the rentals depart radically from a straight-line basis without relation to the economic usefulness of the leased property. The income statement reflects, as expenses, depreciation of the leased property, maintenance and other related costs, as well as the cost of any other services rendered under the provisions of the lease. The amount of these expenses to be recognized in each accounting period should be determined by methods which are appropriate in the circumstances and which are conventionally used for such expenses when incurred in activities other than leasing.

7. *Basis for selection* – The objective of fairly stating the lessor's net income during each of the periods covered by the leasing activities is the most important consideration in differentiating between the use of the financing or operating methods (see Paragraphs 13-15 for a description of balance sheet presentations consistent with the method used in determining income). Pertinent factors in making the choice, among others, are the following: the nature of the lessor's business activities; the specific objectives of its leasing activities, including the relationship to other business activities of the lessor, if any; the term of the lease in relation to the estimated useful life of the property; the existence of renewal or purchase options and the likelihood that the lessee will exercise them; provisions of the lease which indicate the extent to which the usual risks of ownership (e.g., obsolescence, unprofitable operation, unsatisfactory performance, idle capacity, dubious residual value) or rewards of ownership (e.g., profitable operation, gain from appreciation in value at end of lease) rest with the lessor or the lessee.

8. The financing method is generally appropriate for measuring periodic net income from leasing activities of entities engaged in, perhaps among other things, lending money at interest – e.g., lease-finance companies, banks, insurance companies or pension funds. Lease agreements of institutions of this kind typically are designed to pass all or most of the usual ownership risks or rewards to the lessee, and to assure the lessor of, and

generally limit him to, a full recovery of his investment plus a reasonable return on the use of the funds invested, subject only to the credit risks generally associated with secured loans. Usually, the financing method is similar to the method of accounting for revenue already in use for other lending activities of the institutions. The financing method is also appropriate for a leasing activity of an entity which is not identified as a financial institution, such as a manufacturer, if the lease agreements have the characteristics described earlier in this paragraph.

9. On the other hand, there are companies (e.g., the owner-operator of an office building, the lessor of automotive equipment on short-term leases – daily, weekly or monthly) which retain the usual risks or rewards of ownership in connection with their leasing activity. They may also assume responsibilities for maintaining the leased property or furnishing certain related services which will give rise to costs to be incurred in the future. Rental revenues are designed to cover the costs of these services, depreciation and obsolescence, and to provide an adequate profit for assuming the risks involved. In these cases the operating method is appropriate for measuring periodic net income from leasing activities. The operating method is also appropriate if the leasing activity is an integral part of manufacturing, marketing or other operations of a business which generate revenues and costs which must be considered along with revenues and costs from the leasing activities in arriving at appropriate methods for measuring the overall periodic net income (examples are leases of retail outlets with lease provisions deliberately made favorable to induce lessee to handle lessor's product and leases which generate significant servicing revenues and costs). The operating method likewise is appropriate for leasing activities for an otherwise strictly financing institution if such activities are characterized as set forth in this paragraph.

OPINION

10. The Board believes that the financing method of accounting, described in Paragraph 5, should be used for lease financing activities of the type described in Paragraph 8. The Board believes that the operating method, described in Paragraph 6,

should be used for leasing activities of the type described in Paragraph 9. If a single company engages in separate leasing activities of the types described in both Paragraphs 8 and 9, the appropriate accounting method should be used for each type of leasing activity. Where a single lease has both financing and operating characteristics to some degree, the determination of the appropriate accounting method should be made on the basis of which of the two methods described in Paragraphs 5 and 6 will fairly reflect net income. In rare cases, a single lease may require the use of both methods to reflect fairly lessor's net income; a condition precedent to this would be the ability initially to assign aggregate rentals to each of the financing and operating elements.

Initial direct costs

11. When initial direct costs of negotiating and closing leases are reasonably expected to be recovered from revenues, these costs should preferably be deferred and allocated to future periods in which the related revenues are reported. In this context, "initial direct" costs are those costs which are directly associated with consummating the lease (e.g., commissions, legal fees, costs of investigating the lessee's financial status and of preparing and processing documents). The method of allocation to future periods should be consistent with that used to recognize revenue under the financing or operating methods. However, substantially the same net income would be reported under the financing method by expensing initial costs as incurred and recognizing as revenue in the same period, in addition to the normal revenue, a portion of the unearned revenue equal to the initial costs; this method is also acceptable. When initial direct costs of a lessor are reasonably constant in relation to revenues, no practical objection can be raised to a practice of consistently expensing these costs as incurred and recognizing revenue without compensating for initial costs.

Leasing by manufacturers

12. When manufacturers use leases to assist in marketing products or services, the Board believes that the guidelines described in Paragraphs 7, 8 and 9 indicate whether the financing

or operating method is appropriate. Manufacturing revenues (amounts which would have been obtained in a regular sale or the discounted amount of future rentals whichever is lower), costs and profit should be determined at the time of entering into the lease and reported in the income statement of the lessor on the same basis as outright sales of similar manufactured property, provided all of these conditions are met: (a) credit risks are reasonably predictable, (b) the lessor does not retain sizable risks of ownership of the nature described in Paragraph 7 and (c) there are no important uncertainties surrounding the amount of costs yet to be incurred or revenues yet to be earned under the lease. If any of these conditions is not met, manufacturing profit should be recognized, using the operating method, only as realized in the form of rental revenue over the term of the lease. If manufacturing revenue is determined at the time of entering into the lease, the conditions described above having been met, the financing method should be used and the amount of the manufacturing revenue becomes the "cost of the leased property" as that term is used in Paragraph 5. When it is feasible to determine normal selling prices, then revenues, costs and trading profits of dealers and other middlemen should be recognized in the same manner and under the same conditions described above for manufacturers.

Reporting in balance sheet

13. Amounts invested in leasing activities which are significant in relation to other resources or activities should be stated separately in a manner which best describes the nature of the investment. The investment in leasing activities is neither a conventional loan or receivable, nor in the same category as facilities employed in typical manufacturing or commercial operations. The classification and description of the investment should be appropriate in the circumstances and should depend upon whether the financing or operating method of accounting is used.

14. When the financing method is used, the aggregate rentals called for in the lease should be classified with or near receivables and a description used along the lines of "receivables under

contracts for equipment rentals" or "contracts receivable for equipment rentals." When a company is predominantly engaged in leasing activities for which the financing method is appropriate, information should be disclosed regarding future maturities of the rentals receivable. Unearned finance charges or interest (as defined in Paragraph 5) included in the aggregate rentals should be shown as a deduction therefrom.[2] Estimated residual value should be classified separately with or near property, plant and equipment unless the residual value represents an amount expected to be collected from the lessee (e.g., when a favorable purchase option exists), in which case it should be classified with or near notes and accounts receivable. Thus, the investment is represented by the net rentals receivable plus the residual value. Receivables under financing leases are subject to the same considerations as to current or noncurrent classification, where such segregation is appropriate in the balance sheet, as are assets resulting from other activities.[3]

15. When the operating method is used, the investment should be classified with or near property, plant and equipment and a description used along the lines of "investment in leased property," "property held for or under lease," or "property (equipment, buildings, machines, etc.) leased to others"; accumulated allowances for depreciation and obsolescence should be shown as a deduction from the investment.

Disclosure

16. In addition to an appropriate description in the balance sheet of the investment in property held for or under lease (see Paragraphs 13-15), the principal accounting methods used in accounting for leasing activities should be disclosed. Further, where leasing is a substantial portion of a nonfinancing institution's operations, the Board believes that financial statements should disclose sufficient information to enable readers to assess the significance of leasing activities to the company. Leases and leased property are also subject to the conventional disclosure requirements affecting financial statements as, for example, dis-

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[2] See Paragraph 14 of Opinion No. 6 of the Accounting Principles Board.
[3] See Chapter 3A of Accounting Research Bulletin No. 43.

closure of pledges of leased property and leases as security for loans.

Income taxes

17. When lease revenues or expenses are recognized for tax purposes in a period other than the one in which they are recognized for financial reporting, appropriate consideration should be given to allocation of income taxes among accounting periods.

Relationship to APB Opinion No. 5

18. The Board takes notice of a question that has been raised as to whether certain conclusions herein are inconsistent with conclusions in Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee" – specifically, the question is whether leases accounted for on the financing method by lessors should be capitalized by lessees. As indicated in Paragraphs 2 and 7, the Board considers the principal accounting problem of lessors to be the allocation of revenue and expense to accounting periods covered by the lease in a manner that meets the objective of fairly stating the lessor's net income; the Board believes that this objective can be met by application of the financing method when the circumstances are as described in this Opinion. As to the lessee, however, capitalization of leases, other than those which are in substance installment purchases of property, may not be necessary in order to state net income fairly since the amount of the lease rentals may represent a proper charge to income. There continues to be a question as to whether assets and the related obligations should be reflected in the balance sheet for leases other than those that are in substance installment purchases. The Board will continue to give consideration to this question.

Prior lease agreements

19. Unless otherwise stated, Opinions of the Board are not intended to be retroactive. However, the Board believes that the conclusions as to disclosure in Paragraphs 13-16 should apply to lease agreements made prior as well as subsequent to the issuance of this Opinion.

EFFECTIVE DATE OF THIS OPINION

20. Except as noted in Paragraph 19, this Opinion shall be effective for fiscal periods beginning after December 31, 1966. However, the Board encourages earlier application of the provisions of this Opinion where appropriate.

The Opinion entitled "Accounting for Leases in Financial Statements of Lessors" was adopted unanimously by the twenty-one members of the Board.

NOTES

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, Disclosure of Departures From Opinions of Accounting Principles Board, October 1964) *provides that:*

a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.

b. Opinions of the Accounting Principles Board constitute "substantial authoritative support."

c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

Accounting Principles Board (1965-1966)

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