

1993

# Matrix Funding Corporation v. Auditing Divisions, Utah State Tax Commission : Reply Brief

Utah Court of Appeals

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BRIEF

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IN THE UTAH COURT OF APPEALS

930355

MATRIX FUNDING CORPORATION,

Petitioner,

v.

AUDITING DIVISIONS, UTAH  
STATE TAX COMMISSION,

Respondent.

CASE NO. 930355-CA

ON PETITION FOR REVIEW FROM THE UTAH STATE TAX COMMISSION

REPLY BRIEF OF PETITIONER

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IN THE UTAH COURT OF APPEALS

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MATRIX FUNDING CORPORATION,

Petitioner,

v.

AUDITING DIVISION, UTAH STATE TAX COMMISSION,

Respondent.

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REPLY BRIEF OF PETITIONER

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ARGUMENT

1. Standard of Review. At page 1 of its Brief, Respondent asserts that the issue before the Court in this case involves a combined issue of fact and law. Petitioner agrees this case involves questions of law applying a correction of error standard, but disputes that the case involves issues of fact since the facts in this case (as stated by the Utah State Tax Commission ["Commission"] in its Findings of Facts, Conclusions of Law and Decision and Order as set forth in its Declaratory Order, dated December 16, 1992 [attached as Exhibit "A" to Petitioner's Brief]) are fully stipulated between the parties and are not questioned or modified by the Commission.

2. Matrix' Lender/Secured Party Status is not Inconsistent with the Treatment of the Transaction under FASB 13. Respondent, in paragraph 11 at page 7 of its Brief, infers that Matrix' position as a lender/secured party is at odds with the treatment of the transaction as a true lease under the Financial Accounting Standards Board (FASB) Standard 13. Matrix's response is that such a position is not inconsistent because of the definition of terms under FASB 13. Exhibit "B" contains the four tests for an operating lease under FASB 13. The transaction at issue meets the four tests and qualifies as an operating lease under FASB 13. The reason for this is that under FASB 13, contingent rental amounts which become due upon the later occurrence of a change in an index after inception of the lease are not included as rentals in computing whether each of the four FASB 13 criteria of operating lease are met.<sup>1</sup> The FASB 13 provision regarding "contingent rents" (as stated in FASB 29) is an absolute test. In other words, if there is any possibility at the inception of the lease that the

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<sup>1</sup>FASB 29 amends and clarifies FASB 13. FASB 29, at Section 11, states in part:

Paragraph 5 of FASB Statement No. 13 is amended by adding the following subparagraph:

- n. Contingent rentals. [L]ease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payment that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable. (Emphasis added).

contingency may not later apply, the contingent rentals are not counted in the formula.<sup>2</sup> Since the higher contingent rentals are not counted in applying the test for operating lease for accounting purposes, then (a) under the second of the four FASB 13 tests, the purchase option price at lease end is deemed to be 46% (and not nominal because it approximates the property's fair market value at that time which is estimated to be 50%); and (b) under the fourth of the four FASB 13 tests, only the lower base rental amounts are included in determining whether the present value of the rentals exceeds 90% of the fair value of the leased property (and the present value in the case at hand is less than 90%). Accordingly, under FASB 13, the transaction at issue is an operating lease qualifying for off-balance sheet reporting. In summary, it is the "contingent rental" twist of FASB 13 which allows for operating lease treatment for accounting purposes while, in reality, the purchase option is nominal and the Transaction is a "lease intended as security" or in other words, a "financing".

3. The Agreements Point to "One" Financing Arrangement and Not to "Two" Separate Legal Transactions. Respondent, at page 9 of its Brief, concludes that two separate transactions occurred: First, it says, Customer sold the equipment to Matrix. Second, it reasons, as the result of the first transaction, one of two

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<sup>2</sup>FASB 29 further states, at Section 7:

Several respondents stated that contingent rentals should be included in minimum lease payments to the extent that payment by the lessee is probable. The Board rejected that approach primarily because of the subjectivity inherent in estimating probable contingent rentals.

possibilities exist: Either Matrix will lease the equipment to Customer under a true lease, or Matrix will sell the equipment to Customer and retain a security interest. Under either scenario, it concludes, sales tax applies to the second transaction.

In its discussion, Respondent fails to point out a third and the most logical possibility, which is that since the transactional documents are entered into simultaneously as part of one and the same transaction, no separate sale and lease occurs at all, but the transaction is merely a financing arrangement. That this is the intent of the parties is uncontroverted (Petitioner's Brief, Appendix A, Paragraph 7). Respondent has stipulated that both parties will treat the transaction as an interest bearing loan for federal and state income tax purposes (Petitioner's Brief, Appendix B, Paragraph 11). It is also the correct legal conclusion based upon a full analysis of the Utah statutes and case law and the case law from other jurisdictions (See Sections I.B., I.C., I.D., I.E., I.F., II., and III. of Petitioner's Brief).

Upon execution of the documents, there is no point in time at which Matrix has any right to use, alienate, or appropriate to itself the equipment (as a true owner would) or to enjoy the benefits or be responsible with the burdens of ownership of the equipment. All rights to possession, use and enjoyment of the equipment (including rights to all future residual value of the equipment) which come with ownership existed and will continue to exist with the Customer (and solely with Customer) before, during and after the transaction. Similarly, all obligations to maintain,



be responsible for risk of loss, pay property taxes, insure and incur liability for damages caused by the equipment (including loss of all future residual value of the equipment) which come with ownership existed and will continue to exist with the Customer (and solely with Customer) before, during and after the transaction. Respondent concedes that Matrix has no use for the equipment, no desire to use it and looks at the equipment merely as collateral to secure repayment of the loan (Petitioner's Brief, Appendix B, Paragraph 15). Respondent also concedes that Customer, on the other hand, acquired the equipment for use in its business, cannot conduct its business without the equipment, and cannot economically replace the equipment all at once which it would be required to do if it disclaimed ownership at the end of the repayment period (Petitioner's Brief, Appendix B, Paragraph 12). Customer's interest in the equipment, as borne out by the documents and as stated as the intent of both parties, is and always will be that of an ownership interest, and Matrix' interest is that of a lender's security interest (Petitioner's Brief, Appendix B, Paragraphs 5, 10 and 11).

4. Transfer of Title Means Transfer of Ownership. Respondent, at page 9 of its Brief, cites Utah Code Ann. Section 59-1-102(10) in part, which defines a sale as including "any transfer of title . . . of tangible personal property . . . for a consideration." Given the above statutory language, Respondent, at pages 9 and 10, concludes that since the Sales Agreement contains language that title in the equipment will pass to Matrix, the

language (by itself) is sufficient to cause title to pass for sales tax purposes. However, neither the above statute nor any regulation promulgated thereunder, defines what constitutes the "transfer of title." It becomes necessary then to look at other Utah statutes and case law to determine what constitutes "transfer of title".

Utah Code Ann. Title 70A-2 "Sales", defines the respective rights of merchants in the sale of tangible personal property. The drafters of the Model Uniform Commercial Code (upon which the Utah statute is based), realizing the dangers of placing too much emphasis on the concept of "title", state that the UCC was written

"in terms of contract for sale and the various steps of its performance. The legal consequences are stated as following directly from the contract and action taken under it without resorting to the idea of when property or title passed or was to pass as being the determining factor. The purpose is to avoid making practical issues between practical men turn upon the location of an intangible something, the passing of which no man can prove by evidence and to substitute for such abstractions proof of words and actions of a tangible character." (Uniform Commercial Code, Section 2-101, comment) Emphasis added.

While the Utah Code Ann. Section 70A-2-106(1) defines a "sale" to consist "in the passing of title from the seller to the buyer for a price," (a definition strikingly similar to the sales tax definition cited above), the drafters of the UCC intend that "sale" be defined by considering (a) the intent of the contracting parties and (b) the equities between the contracting parties after examining the weightier issues such as which party has an "insurable interest" in goods, (70A-2-501), buyer's right to delivery (70A-2-503), which party has the "risk of loss" (70A-2-

509), whether owner has any obligation for "warranties" (70A-2-313 et seq), buyer's right to the goods (70A-2-601 et. seq.), course of dealing (70A-1-205), and other factors.

Further, in the interpretation of contracts, the paramount consideration is the intention of the contracting parties as it existed at the time of the contracting. Moss Development Company v. Geary, 115 Cal. Rptr. 736 (1974). In determining the intention of the parties in relation to the execution of a contract, "the court may look to the circumstances surrounding the making of the agreement, including the object, nature, and subject matter of the writing, and thereby 'place itself' for this purpose in the same situation in which the parties found themselves at the time of contracting." Cal. Civ. Code, 1647; Code Civ. Proc., 1860; Dunne & Gaston v. Keltner, 123 Cal. Rptr 430 (1975).

In sales tax matters, the Utah Supreme Court has long held that the "intention of the parties at the time of the transaction is the controlling factor of whether or not title has passed." E.C. Olsen Co. v. State Tax Commission, 109 Utah 563 (1946) (Emphasis added). That case involved the question of whether title to personal property passed for purposes of determining if Utah sales tax applied. At page 331, the Court states:

"The question in this case is: Did the title to the boxes pass from the cannery to the grower at the time the grower took possession of the boxes and the cannery charged grower's account for the same? The intention of the parties at the time of the transaction is the controlling factor of whether or not title passed." (Emphasis added)

After examining the responses of the parties to the Commission's

inquiries, the Commission concluded that it was the intent of the parties that title did not pass and the transactions were not sales of boxes to the growers.

The Utah commercial and sales tax statutory provisions cited above construe "passage or transfer of title" to mean "transfer of ownership" as intended by the contracting parties and as borne out by the substance of the relative interests of parties. It is not the intent of these statutory provisions to transfer ownership rights and obligations when, in fact, the parties did not intend, and the circumstances show, that ownership did not transfer. In the case at hand, the parties intend that Matrix shall never own the equipment. (Petitioner's Brief, Appendix B, Paragraph 10). Customer's sole reason for using lease language in the documents is to obtain favorable accounting treatment; otherwise, it would have used standard loan documentation (Petitioner's Brief, Appendix B, Paragraph 8). The furniture and equipment represent a substantial portion of Customer's business assets (Petitioner's Brief, Appendix B, Paragraph 1), and Customer anticipates (a) it will use these assets in its business operations for approximately 10 to 13 years from commencement of the transaction (Appendix B, Paragraph 12), and (b) it would not be economically feasible to replace the furniture and equipment at the end of the 60 month term (Petitioner's Brief, Appendix B, Paragraph 12). Petitioner has no use for the furniture and equipment in its own business operations and, if returned, would not have the capacity to absorb or use the 4,500 separate items of furniture and equipment in its leasing

operations (Petitioner's Brief, Appendix B, Paragraph 15).

Further, Respondent, at page 11 of its Brief, argues that the definition of "sale" under the Utah Uniform Commercial Code does not necessarily define "sale" under the sales tax statute. Respondent cites a Utah case, Allstate Ins. Co. v. Bliss, 725 P.2d 1330, 1333 (Utah 1986), which states in part, "[W]hile the use of a term in one section may have relevance to its usage in another, the plain language of each section must first be considered." While Petitioner does not dispute such holding, it has little relevance in this case. As stated earlier, the phrase "transfer of title" as contained in the sales tax statute is not further defined by either the statute itself or by regulations promulgated thereunder. The meaning of the phrase "transfer of title" for sales tax purposes has, however, been interpreted by the Court in the above referenced Olsen case, where the Court held at page 331, "The intention of the parties at the time of the transaction is the controlling factor of whether or not title passed" (Emphasis added). The Olsen case is directly on point.

5. Possession. Respondent alleges that Petitioner has focused unduly upon the notion that Matrix will never possess the equipment as evidence that no sale occurred. While Matrix recognizes that lack of possession alone will not be determinative of the issue, it nevertheless is one of the many factors cited in Petitioner's Brief which points to a financing rather than a true sale and leaseback.

6. No Second Transaction. The whole of Respondent's

argument at page 12 of its Brief (which focuses upon the taxability for sales tax purposes of the second transaction) is premised upon Respondent's showing that a sale of the equipment actually occurred to Matrix in the first instance. Again, Respondent insists on breaking the transaction down into separate components as if Matrix purchased the equipment one day, then decided to lease it the second day. Based upon the express intent of the parties (that no sale was intended) and Matrix' total lack of any attributes of ownership of the equipment (as pointed out earlier in this Reply Brief), the only plausible conclusion is that the transaction represents a financing, which it is.

Respondent, at page 13, attempts to explain Utah Administrative Rule R865-19-32S(F) (1992) which grants the lessee the option of taxing a purported lease as either a true lease or a conditional sale. That ruling applies, however, only in instances where the purported lessor or seller, actually owned the equipment in the first instance. Matrix will never own the equipment and the above-cited ruling is inapplicable.

7. Case Law from other States. Respondent cites three cases from other states in support of its contention that sale leaseback transactions constitute two separate transactions and not just one integrated transaction. Midwest Fed. Sav. & Loan Ass'n v. Commissioner of Revenue, 259 N.W. 2d 596 (Minn. 1977), is easily distinguished in that the leaseback of the equipment to Midwest was a true lease; Midwest had no option to repurchase the equipment at the end of the repayment period and Midwest received no build-up in

equity from the lease payments paid. Accordingly, the lessor, as owner of the equipment had significant benefits due to its ownership since it could sell the equipment to another party at the end of the lease for its full fair market value. In the case at hand, Matrix will have no residual interest in the equipment at any time during or at the end of the repayment period.

In Honeywell Bull, Inc. CRA Inc. v. Arizona Dep't of Revenue, 1990 WL 92009 (Ariz.Bd.Tax.App. 1990), the Court failed to give any explanation or rationale for its decision other than to say that the Appellant failed to demonstrate that its intent is a legally sufficient basis to deem this to be one transaction. Without further information or explanation, Respondent cannot proffer this case as good and adequate case law to support its position. There is simply insufficient factual basis to compare or distinguish this case from the case at hand.

In Monarch Beverage v. Department of State Revenue, 589 N.E.2d 1209 (Ind.Tax 1992), the two transactions referenced in the decision were not simultaneously undertaken. Rather, the "second" transaction occurred 46 days after the "first". Also, aside from the 46 day time lag, the Court failed to disclose sufficient facts or legal reasoning to compare or distinguish the sale-leaseback with the case at hand.

Respondent has attempted to distinguish the cases from other states cited by Petitioner in its Brief. A brief response to its arguments as to those cases follows: In Footpress Corporation et al. v. Strickland, 251 SE2d 278 (1978), in holding that the sale

leaseback fact pattern created a security arrangement for a loan and not a true sale resulting in no sales tax, the court did not focus on any related party issues but rather focused on the substance of the transaction itself. Respondent's speculation that the result might be different if the parties had been unrelated is unfounded and simply misguides the reader.

Respondent also misconstrues the California Court's holding in Cedars-Sinai Medical Ctr. v. State Bd., 208 Cal Rptr. 837 (1984). Respondent here alleges that the Court defined California's definition of "sale" as not requiring a finding of sale when a transfer of possession occurs. In a footnote, Respondent states, "California's definition of "sale" at issue in Cedars-Sinai contained the language 'any transfer of title or possession'" (Emphasis added). However, in that case, the lessor never took possession of the equipment. At page 838 the Court states: "Possession and control of the equipment were retained by plaintiff and never were acquired by the leasing companies." Since lessor never had possession of the equipment, the Court based its decision that no tax was due by finding that no "sale" ever occurred. The facts in the Cedars-Sinai case closely parallel the facts in the case at hand, and the case represents a good precedent for Utah.

8. Utah Code Ann. Section 70A-1-201(37). Respondent, at page 18 of its Brief, argues that removal of the word "intended" in Utah's 1990 definition of a lease intended as security (Utah Code Ann. Section 70A-1-201(37)) removes entirely any consideration of the intent of the parties in determining whether a transaction



purported to be a lease is in fact a true lease or is merely a lease intended as security. Respondent over-emphasizes the significance of the removal from the statute of the word "intended". In LMV Leasing, Inc. v. Conlin, 805 P.2d 189 (Utah Ct.App. 1991), a case decided after the new Utah Code Ann. Section 70A-1-201(37) was enacted, the Court states at page 195, "when the interpreting court finds no dispositive evidence that the parties intended the agreement to be other than what it purports to be by its unambiguous terms, that court should decline to construe the agreement contrary to those terms." Accordingly, the Utah Supreme Court held even after the statute was rewritten and the word "intended" was removed that an interpreting court should give deference to the intent of the parties. To look only to the language of the documents and ignore the true intent of the parties would set a dangerous precedent for Utah courts. The fair administration of Utah's tax laws requires that the substance of the transaction govern. Certainly neither the Commission nor the courts would want to be bound by a strict construction of a rule which looks only at the form of a transaction, and not at its substance.

However, assuming solely for purposes of discussion here, that intent should be de-emphasized, the substance of the transaction in the case at hand points nevertheless to a lease intended as security and not a true lease. At the end of the repayment period Customer will retain ownership and possession of the equipment for no additional consideration as is demonstrated in Petitioner's

Brief. This fact places the transaction squarely within the statutory definition of lease intended as security as embodied in the new Utah Code Ann. Section 70A-1-201(37).

At pages 20 and 21 of its Brief, Respondent spends considerable time and effort urging that the mention in the documents of the terms "lessor", "lessee" and "master lease agreement" lead to the conclusion that the transaction is a lease. In so doing, Respondent totally ignores the Revised Stipulation of Facts, to which Respondent is signatory, which proclaims the intent and understanding of the parties from the outset to be that the transaction is not a sale followed by a leaseback, but is merely a financing arrangement. Does Respondent contend that the true facts, as set forth in the Revised Stipulation of Facts, should now be wholly set aside while the language of the documents reigns supreme? Such a construction would totally circumvent the purpose of this matter being considered before the Court.

9. No Consideration or Nominal Consideration.

Utah Code Ann. ("UCA") 70A-1-201(37) (1990) at subsection (b) lists four fact situations under which a lease will be deemed a "lease intended as security" and not a "true lease". The fourth fact situation occurs where:

(iv) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

In further explanation and clarification of the above provision, Subsection (d) of the UCA 70A-1-201(37), states in part:

(i) Additional consideration is **not nominal** if . . . when the option [to become the owner of the goods] is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed.

(ii) Additional consideration is **nominal** if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised. (Emphasis added).

At page 22 of its Brief, Respondent makes an erroneous assumption (and misleads the reader) by inferring that a purchase option is "nominal" only if it is less than lessee's cost to perform if the option is not exercised. Such a conclusion was not intended by the drafters of the two provisions<sup>3</sup>. Respondent's

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<sup>3</sup>The examples of "nominal" and "not nominal" were promulgated by the drafters of the Model Uniform Commercial Code ("Model Act") in 1987 and were later adopted as part of the Utah Code Annotated. They were intended as guidelines or safe harbors. In the 1987 Official Comment on Section 1-201(37) of the Model Act, the drafters said concerning these definitions:

There is a set of purchase options whose fixed price is less than fair market value but greater than nominal that must be determined on the facts of each case to ascertain whether the transaction in which the option is included creates a lease or a security interest. (Emphasis Added)

Exhibit A contains numbers interposed into the Matrix transaction at issue. Using those numbers, consider the following illustration: Lessee's option amount is \$190,000; Lessee's cost to perform under the lease if the option price is not elected is \$190,000; the value of the equipment at lease end is \$500,000. If lessee elects to pay the option price, it will essentially pay nothing for the equipment (computed \$190,000 [the option price] less \$190,000 [the termination amount], or nothing more than it is already obligated to pay if it does not elect to pay the option price). The equipment, however, is worth \$500,000. Respondent argues that the consideration is not nominal (even though the equipment is worth \$500,000) because the \$190,000 option price is "not less than" lessee's \$190,000 obligation to perform under the lease. This result is illogical and was not intended by the drafters in the 1987 Official Comment.

reasoning would suggest that the legal distinction between a "true lease" and "lease intended as security" could hinge on a \$1 difference in the option price.<sup>4</sup> As stated above, the drafters of the above provisions did not intend the terms "nominal" and "not nominal" to cover the full range of possibilities. The provisions are not mutually exhaustive. Rather, the provisions were intended as safe harbors so that if the consideration given did fall within the strict terms of either provision, it would be conclusive that such consideration was "nominal" or "not nominal". If, however, the consideration fell in between the two safe harbors, other analysis would be required to determine whether the consideration was nominal or not. For example, additional consideration could be less than fair market value (thus not within subsection (i)), but greater than the cost of performing under the lease (thus not within subsection (ii)). In such cases, the court would be left to decide whether such consideration was nominal or not nominal by looking at case law and the facts and circumstances of each case. It follows that the FMA Financial Corporation, Colonial Leasing,

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<sup>4</sup>In the case at hand, the documents require Customer to either (a) elect to pay the option price of \$190,000, or (b) deliver the furniture and equipment to Matrix and make a final payment of \$190,000. Customer would be required to pay the same amount whether it elected to pay the option price or the final termination amount. Under Respondent's reasoning, if the documents stated instead that Customer could elect to pay an option price of \$190,000 less \$1 (or \$189,999) rather than \$190,000, then the consideration would be nominal and the lease would be for security. Thus, under Respondent's reasoning, true lease status could hinge on a swing of \$1 plus or minus in the purchase option price, which would be a harsh and impractical result.

and First Security Financial Utah cases cited in Petitioner's Brief remain good law and continue to provide valuable assistance in determining whether consideration is nominal or not when it falls between the safe harbors contained in the Utah Code Ann. Section. In the case at hand, since Customer's purchase option price is equal to the amount of Customer's remaining obligation under the Lease, then Customer will be entitled to retain ownership and possession of the equipment at the end of the repayment period for no additional consideration.

At page 23 of its Brief, Respondent attempts to scuttle the ability of the Court to make a determination in this case by alleging that notwithstanding the extensive stipulation of facts, the true fair market value of the equipment at the end of the repayment period cannot be known for sure and so the Court cannot determine whether the final consideration given is nominal. Matrix' response is as follows: (1) Matrix and Customer (dealing with each other at arms length) have each determined and stipulated that the fair market value of the property at the end of the repayment period will approximate 50% of the loan amount<sup>5</sup>. Respondent did not dispute that amount in its concurrence with the Revised Stipulation of Facts. In a matter at bar, if a party fails to dispute a fact (which Respondent did not as signatory to the Revised Stipulation of Facts), the fact stands accepted or proved

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<sup>5</sup>Respondent also stipulated that "Customer has determined it will need the furniture and equipment for its business operations for a period of at least 10 to 13 years," so the furniture and equipment will have a useful life well beyond the repayment period (Petitioner's Brief, Appendix B, Paragraph 12).

before the court. (2) Much time, effort and costs have been expended by the parties in bringing the case to this point. If Respondent is now permitted to dispose of the case by alleging that a material fact is in question, it has acted in bad faith and should be estopped from its untimely pleading. The court should presume for purposes of deciding this matter, that the fact has been accepted or proved. (3) As shown above, if contingent rentals apply (which is highly likely, See Petitioner's Brief, Appendix B, Paragraph 7) Customer must pay the same amount (19% or \$190,000 under the numbers interposed in Exhibit B) whether it elects to pay the purchase option or to pay the final termination amount. In either event, the additional consideration is zero, which will characterize the transaction as a lease intended as security under any fair market value that might later be determined.

At page 24 of its Brief, Respondent alleges that the 19% option price amount constitutes the final consideration, and when compared to the 10% standard used by the Utah courts, constitutes more than nominal consideration. In its analysis, Respondent fails to consider that Customer is obligated to pay a 19% termination amount if it does not elect the purchase option. Accordingly, as shown earlier, the 19% option amount should be reduced by the 19% final termination amount to reflect the true additional consideration, which is zero.

At pages 24 and 25 of its Brief, Respondent refers to the FMA case and alleges that since the fair market value cannot be determined in the case at hand, the Court should apply the rule

used in the FMA case which was that a residual value of 10% implied nominal consideration. Matrix has three responses to this argument. First, the FMA court held that residual values of 10% or less are presumptive of nominal value. The court did not say that any residual values exceed 10% were presumptive of fair market value. That decision would be made on a case by case basis after consideration of all the circumstances in the case. Secondly, in the case at hand, unrebutted testimony has been proffered by both Matrix and its Customer (two parties dealing at arms length) that the equipment will have an approximate fair market value at the end of the repayment period of 50% of the original loan amount. Finally, as noted above, the true option price is zero in any event because it merely replaces an equal termination payment that would otherwise be required. Thus, the court is free to use that fair market value in determining whether any final consideration given, if any, is nominal or not.

#### CONCLUSION

The transaction to be entered into between Matrix and its Customer is one transaction entered into at one time and is, in substance, a financing arrangement. Both Matrix and its Customer intend that ownership of the equipment will never pass to Matrix and that Customer will always remain the owner. Matrix will never enjoy any of the benefits commonly associated with ownership, nor will it incur any of the liabilities commonly associated with ownership. Those attributes will always remain with Customer.

Since ownership of the equipment will never pass to Matrix, no sale will ever occur. Since Matrix will never own the equipment, it cannot in turn lease the equipment to Customer. Since no sale or lease will occur, the transaction in its entirety will not be subject to Utah sales tax. The transaction is merely a financing arrangement.

RESPECTFULLY SUBMITTED this 3rd day of September, 1993

  
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Attorney for Petitioner

CERTIFICATE OF MAILING

I hereby certify that a true and correct copy of the above Reply Brief of Petitioner was mailed, postage pre-paid on this 3rd day of September, 1993, to the following:

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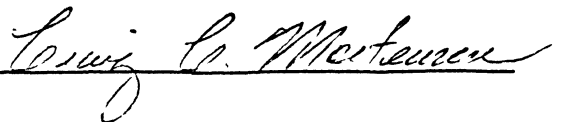




EXHIBIT "A"

The following serves to illustrate the interposition of actual numbers into the Matrix transaction

Original Equipment Cost	\$1,389,000
Loan Amount to Customer (72% of Equipment Cost)	\$1,000,000
Monthly Base Payment	\$ 15,800
Monthly Payment starting in the 13th month if CPI increases (128% of Monthly Base Payment)	\$ 20,220
Option Price if CPI increases (19% of Loan Amount)	\$ 190,000
Option Price if CPI does not increase (46% of Loan Amount)	\$ 460,000
Termination amount which Customer must pay Matrix if it opts to deliver the Equipment to Matrix at the end of the repayment period (19% of Loan Amt)	\$ 190,000
Fair Market Value of Equipment at end of repayment period (50% of Loan Amt)	\$ 500,000
Matrix Rate of Return on Loan Amount if CPI increases	10.6%
Matrix Rate of Return on Loan Amount if CPI does not increase	10.6%

Notes:

- (1) Matrix' Rate of Return is the same 10.6% whether the CPI increases or fails to increase
- (2) Matrix' Rate or Return of 10.6% was calculated as of May, 1991, at the time Matrix requested an advisory option from the Commission. At that time, the prime rate of interest fluctuated at around 10%

	<u>If CPI Increases</u>	
	<u>Option Exercised</u>	<u>Option Not Exercised</u>
Total Rents Paid	\$1,160,160	\$1,160,160
Option Price	190,000	
Termination Price	<u>                    </u>	<u>190,000</u>
Total Amount Received	\$1,350,160	\$1,350,160
Total Amount Received Discounted to Present Value at 10.6%	\$1,000,000	\$1,000,000

EXHIBIT "B"

# Statement of Financial Accounting Standards No. 13 Accounting for Leases

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## INTRODUCTION

This Statement establishes standards of financial accounting and reporting for leases by lessees and lessors. For purposes of this Statement, a lease is defined as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. It is an agreement that, although not nominally called a lease, meets the above definition, such as a "supply contract" for nuclear fuel.<sup>1</sup> This Statement does not include agreements that are contracts or services that do not transfer the right to use property, plant, or equipment from one company to the other. On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease. Leases of this Statement even though substantially the same by the contractor (lessor) may be called in connection with the operation or maintenance of assets. This Statement does not apply to contracts concerning the rights to explore for or exploit natural resources such as oil, gas, coal, and timber. Nor does it apply to licensing contracts for items such as motion picture films, manuscripts, patents, and copyrights.

2. This Statement supersedes *APB Opinion No. 3*, "Reporting of Leases in Financial Statements of Lessee", *APB Opinion No. 7*, "Accounting for Leases in Financial Statements of Lessors"; paragraph 15 of *APB Opinion No. 18*, "The Equity Method of Accounting for Investments in Common Stock", *APB Opinion No. 27*, "Accounting for Lease Transactions by Manufacturer or Dealer Lessors", and *APB Opinion No. 31*, "Disclosure of Lease Commitments by Lessees."

3. This Statement applies to regulated enterprises in accordance with the provisions of the Addendum to *APB Opinion No. 2*, "Accounting for the 'Investment Credit'."

4. Appendix A provides background information. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Illustrations of the accounting and disclosure requirements for lessees and lessors called for by this Statement are contained in Appendixes C and D. An example of the application of the accounting and disclosure provisions for leveraged leases is provided in Appendix E.

<sup>1</sup> This type of contract (also called "burn up") contracts usually provide for payments by the user lessee based upon nuclear fuel utilization in the reactor. The charge for the unrecovered cost base. The residual value usually accrues to the lessee, and the lessor furnishes no service in the financing.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Definitions of Terms

5. For purposes of this Statement, certain terms are defined as follows:

- Related parties in leasing transactions.** A parent company and its subsidiaries, an owner company and its joint ventures (corporate or otherwise) and partnerships, and an investor (including a natural person) and its investees, provided that the parent company, owner company, or investor has the ability to exercise significant influence over operating and financial policies of the related party, as significant influence is defined in *APB Opinion No. 18*, paragraph 17. In addition to the examples of significant influence set forth in that paragraph, significant influence may be exercised through guarantees of indebtedness, extensions of credit, or through ownership of warrants, debt obligations, or other securities. If two or more entities are subject to the significant influence of a parent, owner company, investor (including a natural person), or common officers or directors, those entities shall be considered related parties with respect to each other.
- Inception of the lease.** With the exception noted below, the date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal terms of the transaction. However, if the property covered by the lease has yet to be constructed or has not been acquired by the lessor at the date of the lease agreement or commitment, the inception of the lease shall be the date that construction of the property is completed or the property is acquired by the lessor.
- Fair value of the leased property.** The price for which the property could be sold in an arm's-length transaction between unrelated parties. (See definition of related parties in leasing transactions in paragraph 5(a).) The following are examples of the determination of fair value:
  - When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease (as defined in paragraph 5(b)) will ordinarily be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value shall be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price

and, in some instances, less than the cost of the property.

- When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its cost, reflecting any volume or trade discounts that may be applicable. However, when there has been a significant lapse of time between the acquisition of the property by the lessor and the inception of the lease, the determination of fair value shall be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying amount, if different. (See paragraph 6(b).)
- Bargain purchase option.** A provision allowing the lessee, at his option, to purchase the leased property for a price which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.
- Bargain renewal option.** A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental<sup>2</sup> of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.
- Lease term.** The fixed noncancelable term of the lease plus (i) all periods, if any, covered by bargain renewal options (as defined in paragraph 5(c)), (ii) all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured, (iii) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt related to the leased property is expected to be in effect, (iv) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph 5(d)) is exercisable, and (v) all periods, if any, representing renewals or extensions of the lease at the lessor's option; however, in no case shall the lease term extend beyond the date a bargain purchase option becomes exercisable. A lease which is cancelable (i) only upon the occurrence of some remote contingency, (ii) only with the permission of the lessor, (iii) only if the lessee enters into a new lease with the same lessor, or (iv) only upon payment by the lessee of a penalty in an amount such that continuation of the lease appears, at inception, reasonably assured shall be considered "noncancelable" for purposes of this definition.

<sup>2</sup> "Fair rental" in this context shall mean the expected rental for equivalent property under similar circumstances.

**Estimated economic life of leased property** The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term

**Estimated residual value of leased property** The estimated fair value of the leased property at the end of the lease term (as defined in paragraph 5(f))

**Unguaranteed residual value** The estimated residual value of the leased property (as defined in paragraph 5(h)) exclusive of any portion guaranteed by the lessee<sup>3</sup> or by a third party unrelated to the lessor<sup>4</sup>

#### Minimum lease payments

i From the standpoint of the lessee The payments that the lessee is obligated to make or can be required to make in connection with the leased property However, a guarantee by the lessee of the lessor's debt and the lessee's obligation to pay (apart from the rental payments) executory costs such as insurance, maintenance, and taxes in connection with the leased property shall be excluded If the lease contains a bargain purchase option, only the minimum rental payments over the lease term (as defined in paragraph 5(f)) and the payment called for by the bargain purchase option shall be included in the minimum lease payments Otherwise, minimum lease payments include the following

(a) The minimum rental payments called for by the lease over the lease term

(b) Any guarantee by the lessee<sup>5</sup> of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee When the lessee agrees to make up any deficiency below a stated amount in the lessor's realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made up

5 (c) Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the leased property In this connection, it should be noted that the definition of lease term in paragraph 5(f) includes "all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured" If the lease term has been extended because of that provision, the related penalty shall not be included in minimum lease payments

ii From the standpoint of the lessor The payments described in (i) above plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee<sup>6</sup> or the lessor,<sup>7</sup> provided the third party is financially capable of discharging the obligations that may arise from the guarantee

k. **Interest rate implicit in the lease** The discount rate that, when applied to (i) the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and (ii) the unguaranteed residual value (as defined in paragraph 5(j)) accruing to the benefit of the lessor,<sup>8</sup> causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property (as defined in paragraph 5(c)) to the lessor at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by him (This definition does not necessarily purport to include all factors that a lessor might recognize in determining his rate of return, e.g., see paragraph 44)

l **Lessee's incremental borrowing rate** The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset

m. **Initial direct costs** Those incremental direct costs incurred by the lessor in negotiating and consummating leasing transactions (e.g., commissions and legal fees)

#### Classification of Leases for Purposes of This Statement

6 For purposes of applying the accounting and reporting standards of this Statement, leases are classified as follows

a Classifications from the standpoint of the lessee  
i **Capital leases** Leases that meet one or more of the criteria in paragraph 7

ii **Operating leases** All other leases

b Classifications from the standpoint of the lessor

i **Sales type leases** Leases that give rise to manufacturer's or dealer's profit (or loss) to the lessor (i.e., the fair value of the leased property at the inception of the lease is greater or less than its cost or carrying amount, if different) and that meet one or more of the criteria in paragraph 7 and both of the criteria in paragraph 8 Normally, sales type leases will arise when manufacturers or dealers use leasing as a means of marketing their products Leases involving lessors that are primarily engaged in financing operations normally will not be sales type leases if they qualify under paragraphs 7 and 8, but will most often be direct financing leases, described in paragraph 6(b)(ii) below However, a lessor need not be a dealer to realize dealer's profit (or loss) on a transaction, e.g., if a lessor, not a dealer, leases an asset that at the inception of the lease has a fair value that is greater or less than its cost or carrying amount, if different, such a transaction is a sales type lease, assuming the criteria referred to are met A renewal or an extension<sup>9</sup> of an existing sales-type or direct financing lease shall not be classified as a sales type lease, however, if it qualifies under paragraphs 7 and 8, it shall be classified as a direct financing lease (See paragraph 17(f))

ii **Direct financing leases** Leases other than leveraged leases that do not give rise to manufacturer's or dealer's profit (or loss) to the lessor but that meet one or more of the criteria in paragraph 7 and both of the criteria in paragraph 8 In such leases, the cost or carrying amount, if different, and fair value of the leased property are the same at the inception of the lease An exception arises when an existing lease is renewed or extended<sup>10</sup> In such cases, the fact that the carrying amount of the property at the end of the original lease term is different from its fair value at that date shall not preclude the classification of the renewal or extension as a direct financing lease (See paragraph 17(f))

iii **Leveraged leases** Leases that meet the criteria of paragraph 42

iv **Operating leases** All other leases

#### Criteria for Classifying Leases (Other Than Leveraged Leases)

7 The criteria for classifying leases set forth in this paragraph and in paragraph 8 derive from the concept set forth in paragraph 60 If at its inception (as defined in paragraph 5(b)) a lease meets one or more of the following four criteria, the lease shall be classified as a capital lease by the lessee Otherwise, it shall be classified as an operating lease (See Appendix C for an illustration of the application of these criteria)

a The lease transfers ownership of the property to the lessee by the end of the lease term (as defined in paragraph 5(f))

b The lease contains a bargain purchase option (as defined in paragraph 5(d))

c The lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)) However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease

d The present value at the beginning of the lease term of the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property (as defined in paragraph 5(c)) to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease (as defined in paragraph 5(k)) A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate (as defined in paragraph 5(l)), unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate If both

<sup>3</sup>A guarantee by a third party related to the lessee shall be considered a lessee guarantee

<sup>4</sup>If the guarantor is related to the lessor, the residual value shall be considered as unguaranteed

<sup>5</sup>See footnote 3

<sup>6</sup>See footnote 3

<sup>7</sup>See footnote 4

<sup>8</sup>If the lessor is not entitled to any excess of the amount realized on disposition of the property over a guaranteed amount, no unguaranteed residual value would accrue to his benefit

<sup>9</sup>As used here, renewal or extension includes a new lease under which the lessee continues to use the same property

<sup>10</sup>See footnote 9

of those conditions are met, the lessee shall use the implicit rate.

From the standpoint of the lessor, if at inception lease meets any one of the preceding four criteria and in addition meets both of the following criteria, shall be classified as a sales-type lease or a direct financing lease, whichever is appropriate (see paragraphs 6(b)(i) and 6(b)(ii)). Otherwise, it shall be classified as an operating lease.

Collectibility of the minimum lease payments is reasonably predictable. A lessor shall not be precluded from classifying a lease as a sales-type lease or as a direct financing lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables.

No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs such as insurance, maintenance, and taxes to be paid by the lessor (see paragraphs 17(a) and 18(a)) shall not by itself constitute an important uncertainty as referred to herein.

If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7 and 8 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs 7 and 8 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs 12 and 17(e), any action that extends the lease beyond the expiration of the existing lease term (see paragraph 5(f)), such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the provisions of paragraphs 7-8. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, shall not give rise to a new classification of a lease for accounting purposes.

## Accounting and Reporting by Lessees

### Capital Leases

10. The lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, together with any profit thereon. However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value. If the portion of the minimum lease payments representing executory costs, including profit thereon, is not determinable from the provisions of the lease, an estimate of the amount shall be made. The discount rate to be used in determining present value of the minimum lease payments shall be that prescribed for the lessee in paragraph 7(d). (See Appendix C for illustrations.)

11. Except as provided in paragraphs 25 and 26 with respect to leases involving land, the asset recorded under a capital lease shall be amortized as follows:

- If the lease meets the criterion of either paragraph 7(a) or 7(b), the asset shall be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets.
- If the lease does not meet either criterion 7(a) or 7(b), the asset shall be amortized in a manner consistent with the lessee's normal depreciation policy except that the period of amortization shall be the lease term. The asset shall be amortized to its expected value, if any, to the lessee at the end of the lease term. As an example, if the lessee guarantees a residual value at the end of the lease term and has no interest in any excess which might be realized, the expected value of the leased property to him is the amount that can be realized from it up to the amount of the guarantee.

12. During the lease term, each minimum lease payment shall be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation.<sup>11</sup> (See Appendix C for illustrations.) In leases containing a residual guarantee by the lessee or a penalty for failure to renew the lease at the end of the lease term,<sup>12</sup> following the above method of amortization will result in a bal-

ance of the obligation at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension of the lease term or a new lease under which the lessee continues to lease the same property renders the guarantee or penalty inoperative, the asset and the obligation under the lease shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised agreement shall be computed using the rate of interest used to record the lease initially. In accordance with paragraph 9, other renewals and extensions of the lease term shall be considered new agreements, which shall be accounted for in accordance with the provisions of paragraph 14. Contingent rentals,<sup>13</sup> including rentals based on variables such as the prime interest rate, shall be charged to expense when actually incurred.

13. Assets recorded under capital leases and the accumulated amortization thereon shall be separately identified in the lessee's balance sheet or in footnotes thereto. Likewise, the related obligations shall be separately identified in the balance sheet as obligations under capital leases and shall be subject to the same considerations as other obligations in classifying them with current and noncurrent liabilities in classified balance sheets. Unless the charge to income resulting from amortization of assets recorded under capital leases is included with depreciation expense and the fact that it is so included is disclosed, the amortization charge shall be separately disclosed in the financial statements or footnotes thereto.

14. Prior to the expiration of the lease term, a change in the provisions of a lease, a renewal or extension<sup>14</sup> of an existing lease, and a termination of a lease shall be accounted for as follows:

- If the provisions of the lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (i) does not give rise to a new agreement under the provisions of paragraph 9 or (ii) does give rise to a new agreement but such agreement is also classified as a capital lease, the present balances of the asset and the obligation shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The

present value of the future minimum lease payments under the revised or new agreement shall be computed using the rate of interest used to record the lease initially. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the asset and obligation under the lease shall be removed, gain or loss shall be recognized for the difference, and the new lease agreement shall thereafter be accounted for as any other operating lease.

- Except when a guarantee or penalty is rendered inoperative as described in paragraph 12, a renewal or an extension<sup>15</sup> of an existing lease shall be accounted for as follows:
  - If the renewal or extension is classified as a capital lease, it shall be accounted for as described in subparagraph (a) above.
  - If the renewal or extension is classified as an operating lease, the existing lease shall continue to be accounted for as a capital lease to the end of its original term, and the renewal or extension shall be accounted for as any other operating lease.
- A termination of a capital lease shall be accounted for by removing the asset and obligation, with gain or loss recognized for the difference.

### Operating Leases

15. Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used.

### Disclosures

16. The following information with respect to leases shall be disclosed in the lessee's financial statements or the footnotes thereto (see Appendix D for illustrations).

- For capital leases:
  - The gross amount of assets recorded under capital leases as of the date of each balance sheet presented by major classes according to nature or function. This information may be combined with the comparable information for owned assets.
  - Future minimum lease payments as of the date of the latest balance sheet presented, in

<sup>11</sup>This is the "interest" method described in the first sentence of paragraph 15 of *APB Opinion No. 21*, "Interest on Receivables and Payables," and in paragraphs 16 and 17 of *APB Opinion No. 12*, "Omnibus Opinion—1967."

<sup>12</sup>Residual guarantees and termination penalties that serve to extend the lease term (as defined in paragraph 5(f)) are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph.

<sup>13</sup>The term "contingent rentals" includes all or any portion of the stipulated rental that is contingent.

<sup>14</sup>See footnote 9.

<sup>15</sup>See footnote 9.

the aggregate and for each of the five succeeding fiscal years, with separate deductions from the total for the amount representing executory costs, including any profit thereon, included in the minimum lease payments and for the amount of the imputed interest necessary to reduce the net minimum lease payments to present value (see paragraph 10).

The total of minimum sublease rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

Total contingent rentals (rentals on which the amounts are dependent on some factor other than the passage of time) actually incurred for each period for which an income statement is presented.

For operating leases having initial or remaining noncancelable lease terms in excess of one year:

Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

For all operating leases, rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

A general description of the lessee's leasing arrangements including, but not limited to, the following:

- The basis on which contingent rental payments are determined.
- The existence and terms of renewal or purchase options and escalation clauses.
- Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

#### Accounting and Reporting by Lessors

##### Sales-Type Leases

1. Sales-type leases shall be accounted for by the lessor as follows:

- The minimum lease payments (net of amounts, if any, included therein with respect to executory costs such as maintenance, taxes, and insurance to be paid by the lessor, together with any profit

thereon) plus the unguaranteed residual value (as defined in paragraph 5(i)) accruing to the benefit of the lessor shall be recorded as the gross investment in the lease.

- The difference between the gross investment in the lease in (a) above and the sum of the present values of the two components of the gross investment shall be recorded as unearned income. The discount rate to be used in determining the present values shall be the interest rate implicit in the lease. The net investment in the lease shall consist of the gross investment less the unearned income. The unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.<sup>16</sup> However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. Contingent rentals, including rentals based on variables such as the prime interest rate, shall be credited to income when they become receivable.
- The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs (as defined in paragraph 5(m)), less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.
- The estimated residual value shall be reviewed at least annually. If the review results in a lower estimate than had been previously established, a determination must be made as to whether the decline in estimated residual value is other than temporary. If the decline in estimated residual value is judged to be other than temporary, the accounting for the transaction shall be revised using the changed estimate. The resulting reduction in the net investment shall be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value shall not be made.
- In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,<sup>17</sup> following the method of amortization described in (b) above will result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the guarantee or penalty at that date.

In the event that a renewal or other extension<sup>18</sup> of the lease term renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value shall be adjusted for the changes resulting from the revised agreement (subject to the limitation on the residual value imposed by subparagraph (d) above) and the net adjustment shall be charged or credited to unearned income.

f. Prior to the expiration of the lease term, a change in the provisions of a lease, a renewal or extension<sup>19</sup> of an existing lease, and a termination of a lease shall be accounted for as follows:

- If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement under the provisions of paragraph 9 or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments receivable and the estimated residual value, if affected, shall be adjusted to reflect the change (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment shall be charged or credited to unearned income. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the remaining net investment shall be removed from the accounts, the leased asset shall be recorded as an asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. The new lease shall thereafter be accounted for as any other operating lease.
- Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension<sup>20</sup> of an existing lease shall be accounted for as follows:
  - If the renewal or extension is classified as a direct financing lease, it shall be accounted for as described in subparagraph (f)(i) above.
  - If the renewal or extension is classified as an operating lease, the existing lease shall continue to be accounted for as a sales-type lease to the end of its original term, and the renewal or extension shall be accounted for as any other operating lease.

- A termination of the lease shall be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period.

##### Direct Financing Leases

18. Direct financing leases shall be accounted for by the lessor as follows (see Appendix C for illustrations):

- The minimum lease payments (net of amounts, if any, included therein with respect to executory costs such as maintenance, taxes, and insurance to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value accruing to the benefit of the lessor shall be recorded as the gross investment in the lease.
- The difference between the gross investment in the lease in (a) above and the cost or carrying amount, if different, of the leased property shall be recorded as unearned income. The net investment in the lease shall consist of the gross investment less the unearned income. Initial direct costs (as defined in paragraph 5(m)) shall be charged against income as incurred, and a portion of the unearned income equal to the initial direct costs shall be recognized as income in the same period. The remaining unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.<sup>21</sup> However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method in the preceding sentence. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. Contingent rentals, including rentals based on variables such as the prime interest rate, shall be credited to income when they become receivable.
- In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term,<sup>22</sup> the lessor shall follow the accounting procedure described in paragraph 17(e). The accounting provisions of paragraph 17(f) with respect to renewals and extensions not dealt with in paragraph 17(e), terminations, and other changes in lease provisions shall also be fol-

<sup>18</sup>See footnote 9.

<sup>19</sup>See footnote 9.

<sup>20</sup>See footnote 9.

<sup>21</sup>See footnote 11.

<sup>22</sup>See footnote 12.

<sup>16</sup>See footnote 11.

<sup>17</sup>See footnote 12.



lowed with respect to direct financing leases

- 1 The estimated residual value shall be reviewed at least annually and, if necessary, adjusted in the manner prescribed in paragraph 17(d)

#### Operating Leases

- 19 Operating leases shall be accounted for by the lessor as follows

- a The leased property shall be included with or near property, plant, and equipment in the balance sheet. The property shall be depreciated following the lessor's normal depreciation policy, and in the balance sheet the accumulated depreciation shall be deducted from the investment in the leased property
- b Rent shall be reported as income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight line basis, the income shall be recognized on a straight line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used
- c Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence

#### Participation by Third Parties

20 The sale or assignment of a lease or of property subject to a lease that was accounted for as a sales type lease or direct financing lease shall not negate the original accounting treatment accorded the lease. Any profit or loss on the sale or assignment shall be recognized at the time of the transaction except that (a) when the sale or assignment is between related parties, the provisions of paragraphs 29 and 30 shall be applied, or (b) when the sale or assignment is with recourse, the profit or loss shall be deferred and recognized over the lease term in a systematic manner (e.g., in proportion to the minimum lease payments)

21 The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third party purchaser to another party, shall not be treated as a sale if the seller or any party related to the seller retains substantial risks of ownership in the leased property. A seller may by various arrangements assure recovery of the investment by the third party purchaser in some operating lease transactions and thus retain substantial risks in connection with the property. For example, in the

case of default by the lessee or termination of the lease, the arrangements may involve a formal or informal commitment by the seller to (a) acquire the lease or the property, (b) substitute an existing lease, or (c) secure a replacement lessee or a buyer for the property under a remarketing agreement. However, a remarketing agreement by itself shall not disqualify accounting for the transaction as a sale if the seller (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 priority to the re-leasing or disposition of the property owned by the third party purchaser over similar property owned or produced by the seller. (For example, a first in, first out remarketing arrangement is considered to be a priority.)

22 If a sale to a third party of property subject to an operating lease or of property that is leased by or intended to be leased by the third party purchaser to another party is not to be recorded as a sale because of the provisions of paragraph 21 above, the transaction shall be accounted for as a borrowing (Transactions of these types are in effect collateralized borrowings.) The proceeds from the "sale" shall be recorded as an obligation on the books of the "seller." Until that obligation has been amortized under the procedure described herein, rental payments made by the lessee(s) under the operating lease or leases shall be recorded as revenue by the "seller," even if such rentals are paid directly to the third party purchaser. A portion of each rental shall be recorded by the "seller" as interest expense, with the remainder to be recorded as a reduction of the obligation. The interest expense shall be calculated by application of a rate determined in accordance with the provisions of *APB Opinion No. 21*, "Interest on Receivables and Payables," paragraphs 13 and 14. The leased property shall be accounted for as prescribed in paragraph 19(a) for an operating lease, except that the term over which the asset is depreciated shall be limited to the estimated amortization period of the obligation. The sale or assignment by the lessor of lease payments due under an operating lease shall be accounted for as a borrowing as described above.

#### Disclosures

23 When leasing, exclusive of leveraged leasing, is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the following information with respect to leases shall be disclosed in the financial statements or footnotes thereto (see Appendix D for illustrations)

- a For sales type and direct financing leases
  - i The components of the net investment in sales type and direct financing leases as of

the date of each balance sheet presented:

- (a) Future minimum lease payments to be received, with separate deductions for (i) amounts representing executory costs, including any profit thereon, included in the minimum lease payments and (ii) the accumulated allowance for uncollectible minimum lease payments receivable
- (b) The unguaranteed residual values accruing to the benefit of the lessor
- (c) Unearned income (see paragraphs 17(b) and 18(b))
- ii Future minimum lease payments to be received for each of the five succeeding fiscal years as of the date of the latest balance sheet presented
- iii The amount of unearned income included in income to offset initial direct costs charged against income for each period for which an income statement is presented. (For direct financing leases only)
- iv. Total contingent rentals included in income for each period for which an income statement is presented
- b For operating leases
  - i The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property according to nature or function, and the amount of accumulated depreciation in total as of the date of the latest balance sheet presented
  - ii Minimum future rentals on noncancelable leases as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years
  - iii Total contingent rentals included in income for each period for which an income statement is presented
- c A general description of the lessor's leasing arrangements

#### Leases Involving Real Estate

24 For purposes of this Statement, leases involving real estate can be divided into four categories: (a) leases involving land only, (b) leases involving land and building(s), (c) leases involving equipment as well as real estate, and (d) leases involving only part of a building

#### Leases Involving Land Only

25 If land is the sole item of property leased and the criterion in either paragraph 7(a) or 7(b) is met, the lessee shall account for the lease as a capital lease, otherwise, as an operating lease. If the criteria set forth in paragraph 8 are also met, the lessor shall account for the lease as a sales type or direct financing lease, whichever is appropriate (see paragraphs 6(b)(i) and 6(b)(ii)), otherwise, as an operating lease.

Criteria 7(c) and 7(d) are not applicable to land leases. Because ownership of the land is expected to pass to the lessee if either criterion 7(a) or 7(b) is met, the asset recorded under the capital lease would not normally be amortized.

#### Leases Involving Land and Building(s)

26 Leases involving both land and building(s) shall be accounted for as follows

- a Lease meets either criterion 7(a) or 7(b)
  - i Lessee's accounting. If either criterion (a) or (b) of paragraph 7 is met, the land and building shall be separately capitalized by the lessee. For this purpose, the present value of the minimum lease payments after deducting executory costs, including any profit thereon, shall be allocated between the two elements in proportion to their fair values at the inception of the lease. The building shall be amortized in accordance with the provisions of paragraph 11(a). As stated in paragraph 25, land capitalized under a lease that meets criterion (a) or (b) of paragraph 7 would not normally be amortized.
  - ii Lessor's accounting. If either criterion (a) or (b) of paragraph 7 is met and the criteria of paragraph 8 are also met, the lessor shall account for the lease as a single unit, either as a sales-type lease or as a direct financing lease as appropriate under paragraphs 6(b)(i) and 6(b)(ii). If the criteria of paragraph 8 are not met, the lessor shall account for the lease as an operating lease.
- b Lease meets neither criterion 7(a) nor 7(b)
  - i If the fair value of the land is less than 25 percent of the total fair value of the leased property at the inception of the lease. Both the lessee and the lessor shall consider the land and the building as a single unit for purposes of applying the criteria of paragraphs 7(c) and 7(d). For purposes of applying the criterion of paragraph 7(c), the estimated economic life of the building shall be considered as the estimated economic life of the unit.
    - (a) Lessee's accounting. If either criterion (c) or (d) of paragraph 7 is met, the lessee shall capitalize the land and building as a single unit and amortize it in accordance with the provisions of paragraph 11(b), otherwise, the lease shall be accounted for as an operating lease.
    - (b) Lessor's accounting. If either criterion (c) or (d) of paragraph 7 and the criteria of paragraph 8 are met, the lessor shall account for the lease as a single unit, either as a sales-type lease or as a direct financing lease as appropriate under

paragraphs 6(b)(i) and 6(b)(ii), otherwise, the lease shall be accounted for as an operating lease.

The fair value of the land is 25 percent or more of the total fair value of the leased property at the inception of the lease. Both the lessee and lessor shall consider the land and the building separately for purposes of applying the criteria of paragraphs 7(c) and (d). The minimum lease payments after deducting executory costs, including any profit thereon, applicable to the land and the building shall be separated both by the lessee and the lessor by determining the fair value of the land and applying the lessee's incremental borrowing rate to it to determine the annual minimum lease payments applicable to the land element; the remaining minimum lease payments shall be attributed to the building element.

a) Lessee's accounting. If the building element of the lease meets criterion (c) or (d) of paragraph 7, the building element shall be accounted for as a capital lease and amortized in accordance with the provisions of paragraph 11(b). The land element of the lease shall be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 7, both the building element and the land element shall be accounted for as a single operating lease.

(b) Lessor's accounting. If the building element of the lease meets criterion (c) or (d) of paragraph 7 and the criteria of paragraph 8, the building element shall be accounted for as a sales type lease or a direct financing lease as appropriate under paragraphs 6(b)(i) and 6(b)(ii). The land element of the lease shall be accounted for separately as an operating lease. If the building element of the lease meets neither criterion (c) nor (d) of paragraph 7 or does not meet the criteria of paragraph 8, both the building element and the land element shall be accounted for as a single operating lease.

#### Leases Involving Equipment as Well as Real Estate

If a lease involving real estate also includes equipment, the portion of the minimum lease payments applicable to the equipment element of the lease shall be estimated by whatever means are appropriate in the circumstances. The equipment shall be considered separately for purposes of applying the criteria in paragraphs 7 and 8 and shall be accounted for separately according to its classification by both lessees and lessors.

#### Leases Involving Only Part of a Building

28 When the leased property is part of a larger whole, its cost (or carrying amount) and fair value may not be objectively determinable, as for example, when an office or floor of a building is leased. If the cost and fair value of the leased property are objectively determinable, both the lessee and the lessor shall classify and account for the lease according to the provisions of paragraph 26. Unless both the cost and the fair value are objectively determinable, the lease shall be classified and accounted for as follows:

##### a Lessee

i If the fair value of the leased property is objectively determinable, the lessee shall classify and account for the lease according to the provisions of paragraph 26.

ii If the fair value of the leased property is not objectively determinable, the lessee shall classify the lease according to the criterion of paragraph 7(c) only, using the estimated economic life of the building in which the leased premises are located. If that criterion is met, the leased property shall be capitalized as a unit and amortized in accordance with the provisions of paragraph 11(b).

##### b Lessor. If either the cost or the fair value of the property is not objectively determinable, the lessor shall account for the lease as an operating lease.

Because of special provisions normally present in leases involving terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for purposes of classifying the lease is essentially indeterminate. Likewise, the concept of fair value is not applicable to such leases. Since such leases also do not provide for a transfer of ownership or a bargain purchase option, they shall be classified as operating leases. Leases of other facilities owned by a governmental unit or authority wherein the rights of the parties are essentially the same as in a lease of airport facilities described above shall also be classified as operating leases. Examples of such leases may be those involving facilities at ports and bus terminals.

#### Leases between Related Parties

29 Except as noted below, leases between related parties (as defined in paragraph 5(a)) shall be classified in accordance with the criteria in paragraphs 7 and 8. Insofar as the separate financial statements of the related parties are concerned, the classification and accounting shall be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the

lessee and lessor are related. In such cases the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties shall be disclosed.

30 In consolidated financial statements or in financial statements for which an interest in an investee is accounted for on the equity basis, any profit or loss on a leasing transaction with the related party shall be accounted for in accordance with the principles set forth in *ARB No. 51*, "Consolidated Financial Statements," or *APB Opinion No. 18*, whichever is applicable.

31 The accounts of subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to the parent or other affiliated companies shall be consolidated. The equity method is not adequate for fair presentation of those subsidiaries because their assets and liabilities are significant to the consolidated financial position of the enterprise.

#### Sale-Leaseback Transactions

32 Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller.

33 If the lease meets one of the criteria for treatment as a capital lease (see paragraph 7), the seller-lessee shall account for the lease as a capital lease; otherwise, as an operating lease. Except as noted below, any profit or loss on the sale shall be deferred and amortized in proportion to the amortization of the leased asset.<sup>23</sup> If a capital lease, or in proportion to rental payments over the period of time the asset is expected to be used, if an operating lease. However, when the fair value of the property at the time of the transaction is less than its undepreciated cost, a loss shall be recognized immediately up to the amount of the difference between undepreciated cost and fair value.

34 If the lease meets the criteria in paragraphs 7 and 8, the purchaser/lessor shall record the transaction as a purchase and a direct financing lease; otherwise, he shall record the transaction as a purchase and an operating lease.

#### Accounting and Reporting for Subleases and Similar Transactions

35 This section deals with the following types of leasing transactions:

##### a The leased property is re-leased by the original

lessee to a third party, and the lease agreement between the two original parties remains in effect (a sublease).

b A new lessee is substituted under the original lease agreement. The new lessee becomes the primary obligor under the agreement, and the original lessee may or may not be secondarily liable.

c A new lessee is substituted through a new agreement, with cancellation of the original lease agreement.

#### Accounting by the Original Lessor

36 If the original lessee enters into a sublease or the original lease agreement is sold or transferred by the original lessee to a third party, the original lessor shall continue to account for the lease as before.

37 If the original lease agreement is replaced by a new agreement with a new lessee, the lessor shall account for the termination of the original lease as provided in paragraph 17(f) and shall classify and account for the new lease as a separate transaction.

#### Accounting by the Original Lessee

38 If the nature of the transaction is such that the original lessee is relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraphs 35(b) and 35(c), the termination of the original lease agreement shall be accounted for as follows:

a If the original lease was a capital lease, the asset and obligation representing the original lease shall be removed from the accounts, gain or loss shall be recognized for the difference, and, if the original lessee is secondarily liable, the loss contingency shall be treated as provided by *FASB Statement No. 5*, "Accounting for Contingencies." Any consideration paid or received upon termination shall be included in the determination of gain or loss to be recognized.

b If the original lease was an operating lease and the original lessee is secondarily liable, the loss contingency shall be treated as provided by *FASB Statement No. 5*.

39 If the nature of the transaction is such that the original lessee is not relieved of the primary obligation under the original lease, as would be the case in transactions of the type described in paragraph 35(a), the original lessee, as sublessor, shall account for the transaction as follows:

a If the original lease met either criterion (a) or (b) of paragraph 7, the original lessee shall classify the new lease in accordance with the criteria of

<sup>23</sup>If the leased asset is land only the amortization shall be on a straight line basis over the lease term.

- paragraphs 7 and 8. If the new lease meets one of the criteria of paragraph 7 and both of the criteria of paragraph 8, it shall be accounted for as a sales type or direct financing lease, as appropriate, and the unamortized balance of the asset under the original lease shall be treated as the cost of the leased property. If the new lease does not qualify as a sales type or direct financing lease, it shall be accounted for as an operating lease. In either case, the original lessee shall continue to account for the obligation related to the original lease as before.
- b If the original lease met either criterion (c) or (d) but not criterion (a) or (b) of paragraph 7, the original lessee shall, with one exception, classify the new lease in accordance with the criteria of paragraphs 7(c) and 8 only. If it meets those criteria, it shall be accounted for as a direct financing lease, with the unamortized balance of the asset under the original lease treated as the cost of the leased property; otherwise, as an operating lease. In either case, the original lessee shall continue to account for the obligation related to the original lease as before. The one exception arises when the timing and other circumstances surrounding the sublease are such as to suggest that the sublease was intended as an integral part of an overall transaction in which the original lessee serves only as an intermediary. In that case, the sublease shall be classified according to the criteria of paragraphs 7(c) and 7(d), as well as the criteria of paragraph 8. In applying the criterion of paragraph 7(d), the fair value of the leased property shall be the fair value to the original lessor at the inception of the original lease.
- c If the original lease is an operating lease, the original lessee shall account for both it and the new lease as operating leases.
- a Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph 6(b)(ii), it otherwise meets that definition. Leases that meet the definition of sales type leases set forth in paragraph 6(b)(i) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph 17.
- b It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
- c The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial "leverage" in the transaction.
- d The lessor's net investment, as defined in paragraph 43, declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

A lease meeting the preceding definition shall be accounted for by the lessor using the method described in paragraphs 43-47, an exception arises if the investment tax credit is accounted for other than as stated in paragraphs 43 and 44,<sup>24</sup> in which case the lease shall be classified as a direct financing lease and accounted for in accordance with paragraph 18. A lease not meeting the definition of a leveraged lease shall be accounted for in accordance with its classification under paragraph 6(b).

43 The lessor shall record his investment in a leveraged lease net of the nonrecourse debt. The net of the balances of the following accounts shall represent the initial and continuing investment in leveraged leases:

- a Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt.
- b A receivable for the amount of the investment tax credit to be realized on the transaction.
- c The estimated residual value of the leased asset.
- d Unearned and deferred income consisting of (i) the estimated pretax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income over the lease term and (ii) the investment tax credit remaining to be allocated to income over the lease term.

The investment in leveraged leases less deferred taxes arising from differences between pretax accounting income and taxable income shall represent the lessor's net investment in leveraged leases for purposes of computing periodic net income from the lease, as described in paragraph 44.

44 Given the original investment and using the projected cash receipts and disbursements over the term of the lease, the rate of return on the net investment in the years<sup>25</sup> in which it is positive shall be computed. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the net income to those years (see Appendix E, Schedule 3) and is distinct from the interest rate implicit in the lease as defined in paragraph 5(k). In each year, whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The net income recognized shall be composed of three elements: two, pretax lease income (or loss) and investment tax credit, shall be allocated in proportionate amounts from the unearned and deferred income included in net investment, as described in paragraph 43; the third element is the tax effect of the pretax lease income (or loss) recognized, which shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes. The accounting prescribed in paragraph 43 and in this paragraph is illustrated in Appendix E.

45 If the projected net cash receipts<sup>26</sup> over the term of the lease are less than the lessor's initial investment, the deficiency shall be recognized as a loss at the inception of the lease. Likewise, if at any time during the lease term the application of the method prescribed in paragraphs 43 and 44 would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in cases where one of the important assumptions affecting net income is revised (see paragraph 46).

46 Any estimated residual value and all other important assumptions affecting estimated total net income from the lease shall be reviewed at least annually. If during the lease term the estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary or if the revision of another impor-

tant assumption changes the estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph 44 and using the revised assumption. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. An upward adjustment of the estimated residual value shall not be made. The accounting prescribed in this paragraph is illustrated in Appendix E.

47 For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment), as prescribed in *APB Opinion No. 11*, "Accounting for Income Taxes," paragraphs 57, 59, and 64. In the income statement or the notes thereto, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period. When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases as set forth in paragraph 43 shall be disclosed in the footnotes to the financial statements. Appendix E contains an illustration of the balance sheet, income statement, and footnote presentation for a leveraged lease.

#### Effective Date and Transition

48 The preceding paragraphs of this Statement shall be effective for leasing transactions and lease agreement revisions (see paragraph 9) entered into on or after January 1, 1977. However, leasing transactions or revisions of agreements consummated on or after January 1, 1977 pursuant to the terms of a commitment made prior to that date and renewal options exercised under agreements existing or committed prior to that date shall not be considered as leasing transactions or lease agreement revisions entered into after January 1, 1977 if such commitment is in writing, signed by the parties in interest to the transaction, including the financing party,<sup>27</sup> if any, when specific financing is essential to the transaction, and specifically sets forth the principal terms

#### Accounting by the New Lessee

40 The new lessee shall classify the lease in accordance with the criteria of paragraph 7 and account for it accordingly.

#### Accounting and Reporting for Leveraged Leases

41 From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as non leveraged leases. The balance of this section deals with leveraged leases from the standpoint of the lessor.

42 For purposes of this Statement, a leveraged lease is defined as one having all of the following characteristics:

<sup>24</sup>It is recognized that the investment tax credit may be accounted for other than as prescribed in this Statement as provided by Congress in the Revenue Act of 1971.

<sup>25</sup>The use of the term "years" is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods.

<sup>26</sup>For purposes of this paragraph, net cash receipts shall be gross cash receipts less gross cash disbursements exclusive of the lessor's initial investment.

<sup>27</sup>For purposes of this paragraph, the term "financing party" shall include an interim lender pending long term financing.

he transaction. The disclosures called for in the preceding paragraphs of this Statement shall be included in financial statements for calendar or fiscal years ending after December 31, 1976.<sup>28</sup> Earlier application of the preceding paragraphs of this Statement, including retroactive application to all leases regardless of when they were entered into or omitted is encouraged but, until the effective date specified in paragraph 49, is not required. If applied retroactively, financial statements presented for prior periods shall be restated according to the provisions of paragraph 51.

For purposes of financial statements for calendar or fiscal years beginning after December 31, 1980, paragraphs 1-47 of this Statement shall be applied retroactively, and any accompanying financial statements presented for prior periods shall be stated as may be required by the provisions of paragraph 51.

If paragraphs 1-47 are not applied initially on a retroactive basis, as permitted by paragraph 48, those leases existing or committed at December 31, 1976 shall be subject to the following provisions until such time as paragraphs 1-47 are applied retroactively to all leases:

For purposes of applying the presentation and disclosure requirements of this Statement applicable to lessees, those leases existing or committed at December 31, 1976 that are capitalized in accordance with the provisions of superseded *APB Opinion No. 5* shall be considered as capital leases, and those leases existing or committed at December 31, 1976 that are classified and accounted for as operating leases shall be considered as operating leases. For those leases that are classified and accounted for as operating leases but that meet the criteria of paragraph 7 for classification as capital leases, separate disclosure of the following information shall be made for purposes of financial statements for the year ending December 31, 1977 and for years ending thereafter:

- i The amounts of the asset and the liability that would have been included in the balance sheet had those leases been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the financial statements referred to in paragraph 50(a) above.
- ii The effect on net income that would have resulted if those leases had been classified and

accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.

For purposes of applying the presentation and disclosure requirements of this Statement applicable to lessors, those leases existing or committed at December 31, 1976 that are accounted for as sales, financing leases, and as operating leases in accordance with superseded *APB Opinions No. 7* and *27* shall be considered as sales type leases, as direct financing leases, and as operating leases, respectively (Refer to (c) below for provisions applicable to leveraged leases.) For those leases existing or committed at December 31, 1976 that are classified and accounted for as operating leases but that meet the criteria of paragraphs 7 and 8 for classification as direct financing leases or sales type leases, separate disclosure of the following information shall be made for purposes of financial statements for the year ending December 31, 1977 and for years ending thereafter:

- i The amount of the change in net worth that would have resulted had the leases been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the foregoing financial statements referred to in paragraph 50(b) above.
- ii The effect on net income that would have resulted if the leases had been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.

For those leases that meet the criteria of paragraph 42 (leveraged leases) but that are accounted for other than as prescribed in paragraphs 1-47, separate disclosure of the following information shall be made for purposes of lessors' financial statements for the year ending December 31, 1977 and for years ending thereafter:

- i The amounts of the net changes in total assets and in total liabilities that would have resulted had the leases been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be

disclosed for balance sheets as of December 31, 1976 and thereafter when such balance sheets are included in the financial statements referred to in paragraph 50(c) above.

- ii The effect on net income that would have resulted if the leases had been classified and accounted for in accordance with the provisions of paragraphs 1-47. This information shall also be disclosed for income statements for periods beginning after December 31, 1976 when such income statements are included in the aforementioned financial statements.

Paragraph 49 requires retroactive application of paragraphs 1-47 for purposes of financial statements for calendar or fiscal years beginning after December 31, 1980, and paragraph 48 encourages earlier retroactive application. If after retroactive application is adopted, financial statements for earlier periods and financial summaries or other data derived from them are presented, they shall be restated in accordance with the following requirements to conform to the provisions of paragraphs 1-47:

- a Such restatements shall include the effects of leases that were in existence during the periods covered by the financial statements even if those

leases are no longer in existence.

- b Balance sheets presented as of December 31, 1976 and thereafter and income statements presented for periods beginning after December 31, 1976 and financial summaries and other data derived from those financial statements shall be restated to conform to the provisions of paragraphs 1-47.
- c Balance sheets as of dates before December 31, 1976 and income statements for periods beginning before December 31, 1976 shall, when presented, be restated to conform to the provisions of paragraphs 1-47 for as many consecutive periods immediately preceding December 31, 1976 as is practicable. Summaries or other data presented based on such balance sheets and income statements shall be treated in like manner.
- d The cumulative effect of applying paragraphs 1-47 on the retained earnings at the beginning of the earliest period restated shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20*, "Accounting Changes").<sup>29</sup>

The effect on net income of applying paragraphs 1-47 in the period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating the prior periods presented shall be explained.

**The provisions of this Statement need not be applied to immaterial items**

*This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Mr. Kirk dissented.*

Mr. Kirk dissents primarily because he does not believe that the front ending of lease income required by paragraph 44 for leveraged leases versus the method of lease income recognition required by paragraph 18(b) for direct financing leases is justified by any significant economic (i.e., cash flow) differences between the two types of leases. The front ending of leveraged lease income results from treating the related debt and deferred tax benefits (principally the latter) as valuation accounts, and Mr. Kirk believes that the treatment as valuation accounts is unwarranted.

The leasing business is a leveraged business. Many leases are partially financed by recourse debt, some leases are partially financed by nonrecourse debt. Mr. Kirk believes the cash inflows from the lessee and the outflows to the creditor can be similar whether the debt is recourse or nonrecourse, and he does not believe that a difference in the method of financing a lease should be a factor in determining the pattern of recognizing lease income (and interest

expense) as is required by this Statement. Mr. Kirk also objects to the inconsistent classification of nonrecourse debt required by this Statement (i.e., if the lease meets the criteria of paragraph 42, the nonrecourse debt financing the lease is a valuation account and *not* a liability, if the lessor is the manufacturer of the leased asset or if the lease does not meet all the criteria of paragraph 42, the nonrecourse debt *is* a liability).

The amount and timing of the cash flow benefits resulting from the tax attributes of a leased asset are the same to the lessor whether he finances the asset with recourse debt, with nonrecourse debt, or with equity. A difference in the method of financing the lease should not, in the opinion of Mr. Kirk, result in a difference in accounting for deferred taxes. This Statement, however, requires that deferred income tax balances arising from tax timing differences be accounted for as a valuation account (for purposes of computing periodic lease income) only if (a) the lease is financed with *substantial* nonrecourse debt

<sup>28</sup>For an enterprise having a fiscal year of 52 or 53 weeks ending in the last seven days in December or the first seven days in January, references to December 31 in paragraphs 48-51 shall mean the date in December or January on which the fiscal year ends.

<sup>29</sup>Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* are not applicable.

and (b) the lessor accounts for the benefit from the investment tax credit as a valuation account. The special treatment of these deferred tax benefits as valuation accounts results in a net investment that declines in the early years and rises during the later years that result then requires the front ending of lease income. Also, Mr. Kirk can see no reason why the method of accounting for the investment tax credit should determine the accounting for deferred income taxes and, therefore, the pattern of lease income recognition.

Mr. Kirk also believes the treatment of deferred taxes and the required method of accounting for changes in assumptions (paragraph 46) result in the deferred taxes related to leveraged leases being accounted for by the *liability method*, which is not in conformity with the requirements of *APB Opinion No. 11*, "Accounting for Income Taxes," and the accounting for deferred taxes related to other leases.

In order to avoid having (a) the method of financing, (b) the debt repayment schedule, and (c) the method of accounting for deferred tax benefits

influence the pattern of recognition of lease income, interest expense, and initial direct costs (as is the case for those leases meeting the criteria of paragraph 42), Mr. Kirk believes it is necessary to use the ordinary financing lease method (paragraph 109(a)) for all financing leases, including those financed with nonrecourse debt. However, in view of the present inconsistencies in accounting for nonrecourse debt, Mr. Kirk would not have dissented to a requirement that the three party financing lease method (paragraph 109(b)) be used for financing leases financed with nonrecourse debt. Both methods avoid the inconsistent treatment of nonrecourse debt and the front-ending of lease income.

Mr. Kirk also dissents because he objects to the exemption in paragraph 28 that applies to certain facilities leased from governmental units because of special provisions *normally* present in those leases. Mr. Kirk believes the classification of all leases, regardless of the nature of the asset or lessor, should be determined by application of the criteria in paragraphs 7 and 8.

#### Members of the Financial Accounting Standards Board

Marshall S. Armstrong,  
Chairman  
Oscar S. Gellen

Donald J. Kirk  
Arthur L. Litke

Robert E. Mays  
Robert T. Sprouse

#### Appendix A

#### BACKGROUND INFORMATION

52 The growing importance of leasing as a financing device was recognized by the accounting profession as early as 1949, when the AICPA issued *Accounting Research Bulletin No. 38*, "Disclosure of Long Term Leases in Financial Statements of Lessees." In early 1960, the newly formed APB recognized the importance of the matter by including lease accounting as one of the first five topics to be studied by the AICPA's Accounting Research Division. That project culminated in 1962 with the publication of *Accounting Research Study No. 4*, "Reporting of Leases in Financial Statements," and shortly thereafter the APB took up the subject. In all, during the ten years ending June 30, 1973, the APB issued four Opinions (No. 5, 7, 27, and 31) dealing with leases. They were supplemented by three AICPA Accounting Interpretations. The last of the APB Opinions, *APB Opinion No. 31*, "Disclosure of Lease Commitments by Lessees," as its name implies, dealt only with disclosure. The APB had previously acknowledged that certain questions remained in connection with Opinions 5 and 7 and had publicly announced its intention to give those questions further consideration. The APB decided, however, to deal only with additional disclosure

requirements. In paragraph 5 of *APB Opinion No. 31*, which was approved in June 1973, the APB noted that

disclosure of lease commitments is part of the broad subject of accounting for leases by lessees, a subject which has now been placed on the agenda of the Financial Accounting Standards Board. The Board [APB] also recognizes that the forthcoming report of the Study Group on the Objectives of Financial Statements may contain recommendations which will bear on this subject and which the FASB may consider in its deliberations. Accordingly, the Board is refraining from establishing any disclosure requirements which may prejudice or imply any bias with respect to the outcome of the FASB's undertaking, particularly in relation to the questions of which leases, if any, should be capitalized and how such capitalization may influence the income statement. Nevertheless, in the meantime the Board recognizes the need to improve the disclosure of lease commitments in order that users of financial statements may be better informed.

53 The SEC, too, has issued a number of pronouncements on accounting for leases, including three Accounting Series Releases No. 132, 141, and 147, adopted on October 5, 1973. The latter Release

imposes essentially the same disclosure requirements with respect to total rental expense and minimum rental commitments as *APB Opinion No. 31*. However, it makes mandatory the disclosure of the present value of certain lease commitments (defined differently from the optional present value disclosure included in *APB Opinion No. 31*). In addition, it requires disclosure of the impact on net income had "financing" leases been capitalized, a disclosure not called for by *APB Opinion No. 31*.

54 Despite the attention that the accounting profession has given to the matter of accounting for leases, inconsistencies remain in lease accounting practices, and differences of opinion as to what should be done about them remain. In recognition of that fact, the FASB placed on its initial agenda a project on Accounting for Leases. In October 1973, a task force of 11 persons from industry, government, public accounting, the financial community, and academe was appointed to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

55 As indicated above, accounting for leases is a subject which has been thoroughly studied over a long period of time and on which numerous pronouncements have been made. Extensive research has been carried out, several public hearings have been held for which position papers were filed by many interested parties and groups, especially appointed committees, not only of the Accounting Principles Board, but of a number of other organizations, have analyzed and debated the issues. A considerable number of the studies and articles on lease accounting were available to the Board, many of which are summarized or identified in the Discussion Memorandum. In addition, the FASB staff surveyed the accounting and reporting practices of a number of lessee and lessor companies, the results of which are set forth in Appendix C to the Discussion Memorandum. The staff also met on a number of occasions with representatives of various organizations interested in leasing for the purpose of obtaining specialized information helpful to the Board's consideration of the various issues involved in accounting for leases.

56 The Board issued its Discussion Memorandum on July 2, 1974, and on November 18-21, 1974 held a public hearing on the subject. The Board received 306 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum, and 32 presentations were made at the public hearing.

57 On August 26, 1975, the Financial Accounting Standards Board issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards on Accounting for Leases that, if adopted, would

have been effective for leasing transactions entered into on or after January 1, 1976. Two hundred and fifty letters of comment were received in response to that Exposure Draft. The Board announced on November 25, 1975 that, because of the need to analyze the large number of responses and the complexity of the issues involved, it would be unable to issue a final Statement in 1975 but expected to do so early in 1976. A further announcement made by the Board on June 2, 1976 stated that a number of modifications were being made to the Exposure Draft and that a second Exposure Draft would be issued for public comment preparatory to the expected issuance of a final Statement in 1976.

58 The Board issued the second Exposure Draft of a Proposed Statement of Financial Accounting Standards on Accounting for Leases on July 22, 1976. Two hundred and eighty-two letters of comment were received in response to that Exposure Draft.

#### Appendix B

#### BASIS FOR CONCLUSIONS

59 This Appendix discusses factors deemed significant by the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

60 The provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase. This is not to say, however, that such transactions are necessarily "in substance purchases" as that term is used in previous authoritative literature.

61 The transfer of substantially all the benefits and risks of ownership is the concept embodied in previous practice in lessors' accounting, having been articulated in both *APB Opinion No. 7*, "Accounting for Leases in Financial Statements of Lessors," and *APB Opinion No. 27*, "Accounting for Lease Transactions by Manufacturer or Dealer Lessors," as a basis for determining whether a lease should be accounted for as a financing or sale or as an operating lease. However, a different concept has existed in the authoritative literature for lessees' accounting, as evidenced by *APB Opinion No. 31*, "Reporting of Leases in Financial Statements of Lessee."