# Statement of Financial Accounting Standards No. 28

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## Accounting for Sales with Leasebacks

(an amendment of FASB Statement No. 13)

May 1979

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Paragraph Numbers

# FAS 28: Accounting for Sales with Leasebacks

## an amendment of FASB Statement No. 13


### FAS 28 Summary

Paragraph 33 of *FASB Statement No. 13,* "Accounting for Leases," generally treats a sale-leaseback as a single financing transaction in which any profit or loss on the sale is deferred and amortized by the seller, who becomes the lessee. This Statement requires the seller to recognize some profit or loss in either of the following limited circumstances:

- If the seller retains the use of only a minor part of the property or a minor part of its remaining useful life through the leaseback, the sale and the lease would be accounted for based on their separate terms. However, if the rentals called for by the lease are unreasonable in relation to current market conditions, an appropriate amount would be deferred or accrued by adjusting the profit or loss on the sale. The amount deferred or accrued would be amortized as an adjustment of those rentals.
- If the seller retains more than a minor part but less than substantially all of the use of the property through the leaseback and the profit on the sale exceeds the present value of the minimum lease payments called for by the leaseback for an operating lease or the recorded amount of the leased asset for a capital lease, that excess would be recognized as profit at the date of the sale.


## INTRODUCTION

1. The FASB has been asked whether the description of sale-leaseback transactions in paragraph 32 of *FASB Statement No. 13,* "Accounting for Leases," is intended to mean that any sale with a leaseback of all or any part of the property for all or part of its remaining life is subject to the sale-leaseback provisions of Statement No. 13. Paragraph 32 of Statement No. 13 states that "sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller." Those making the inquiry noted that deferral of the profit on a sale and amortization of that profit over the term of the leaseback would appear to be

inappropriate in some cases in which the leaseback covers only a relatively small part of the property sold or the leaseback is for only a relatively short period of time. They noted that in some cases the profit on the sale might exceed the total rentals under the leaseback, resulting in a negative rental if the accounting provisions of Statement No. 13 were followed. Appendix A provides additional background information about this matter. Appendix B provides illustrations of accounting for sales with leasebacks.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Amendments to FASB Statement No. 13

2. Paragraph 32 of *FASB Statement No. 13* is superseded by the following:

> Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the seller-lessee in accordance with the provisions of paragraph 33 [of Statement No. 13] and shall be accounted for by the purchaser-lessor in accordance with the provisions of paragraph 34 [of Statement No. 13].

3. Paragraph 33 of FASB Statement No. 13 is superseded by the following:

> If the lease meets one of the criteria for treatment as a capital lease (see paragraph 7 [of Statement No. 13]), the seller-lessee shall account for the lease as a capital lease; otherwise as an operating lease. Any profit or loss on the sale* shall be deferred and amortized in proportion to the amortization of the leased asset,[23] if a capital lease, or in proportion to the related gross rental charged to expense over the lease term, if an operating lease, unless:
>
> a. The seller-lessee relinquishes the right to substantially all of the remaining use of the property sold (retaining only a minor portion of such use),[+] in which case the sale and the leaseback shall be accounted for as separate transactions based on their respective terms. However, if the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease, an appropriate amount shall be deferred or accrued, by adjusting the profit or loss on the sale, and amortized as specified in the introduction of this paragraph to adjust those rentals to a reasonable amount.
> b. The seller-lessee retains more than a minor part but less than substantially all[++] of the use of the property through the leaseback and realizes a profit on

the sale** in excess of (i) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or (ii) the recorded amount of the leased asset, if the leaseback is classified as a capital lease. In that case, the profit on the sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, shall be recognized at the date of the sale. For purposes of applying this provision, the present value of the minimum lease payments for an operating lease shall be computed using the interest rate that would be used to apply the 90 percent recovery criterion of paragraph 7(d) [of Statement No. 13].

c. The fair value of the property at the time of the transaction is less than its undepreciated cost, in which case a loss shall be recognized immediately up to the amount of the difference between undepreciated cost and fair value.

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*"Profit or loss on the sale" is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to the *AICPA Industry Accounting Guide,* "Accounting for Profit Recognition on Sales of Real Estate," the profit on the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with the Guide.

+"Substantially all" and "minor" are used here in the context of the concepts underlying the classification criteria of *FASB Statement No. 13.* In that context, a test based on the 90 percent recovery criterion of Statement No. 13 could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.

++Substantially all" is used here in the context of the concepts underlying the classification criteria of *FASB Statement No. 13.* In that context, if a leaseback of *the entire property sold* meets the criteria of Statement No. 13 for classification as a capital lease, the seller-lessee would be presumed to have retained substantially all of the remaining use of the property sold.

**See footnote*.

## Effective Date and Transition

4. The provisions of this amendment to *FASB Statement No. 13* shall be effective for leasing transactions recorded and lease agreement revisions (see paragraph 9 of Statement No. 13) recorded as of September 1, 1979 or thereafter. Earlier application is encouraged. In addition, except as provided in the next sentence, the provisions of this Statement shall be applied retroactively at the same time and in the same manner as the provisions of Statement No. 13 are applied retroactively (see paragraphs 49 and 51 of Statement No. 13). Enterprises that have already applied the provisions of Statement No. 13 retroactively and have published annual financial statements based on the retroactively adjusted accounts before the effective date of this Statement may, but are not required to, apply the provisions of this Statement retroactively.

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

*This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:*

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

## Appendix A: BACKGROUND INFORMATION

5. Paragraph 33 of *FASB Statement No. 13* requires that with one stated exception any profit or loss on the sale in a sale-leaseback transaction be deferred by the seller-lessee and amortized. Paragraph 33 states:

> 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,...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.

6. Paragraph 107 of *FASB Statement No. 13* explains that the seller-lessee's accounting for a sale-leaseback transaction, described in paragraph 5 above, was prescribed because no means could be identified for separating the sale and the leaseback that would be both practicable and objective, with one exception. The one exception was that if an asset had a fair value less than its undepreciated cost at the time of the transaction, a loss should be recognized up to the amount of the difference between undepreciated cost and fair value. Upon further consideration, the Board has concluded that it should provide two additional exceptions.

7. Paragraph 34 of *FASB Statement No. 13* requires the purchaser-lessor in a sale-leaseback transaction to classify the lease as a direct financing lease or an operating lease, based on the criteria of Statement No. 13 for those classifications. The principal effect of that paragraph is to prohibit the purchaser-lessor from classifying the lease to the seller-lessee as a sales-type lease.

Paragraph 34 states:

> 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.

8. The Board concluded that the provisions of paragraph 34 of *FASB Statement No. 13* should not be modified to permit a purchaser-lessor in a sale and leaseback transaction to classify the lease as a sales-type lease.

9. An Exposure Draft of a proposed Statement on "Accounting for Sales with Leasebacks" was issued on December 21, 1978. The Board received 37 letters of comment in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in paragraphs 10-21 below.

**Sales with "Minor" Leasebacks**

10. This Statement requires that sales with minor leasebacks be accounted for based on the separate terms of the sale and of the leaseback except when the rentals called for by the leaseback are unreasonable in relation to current market conditions. If the rentals called for by the leaseback are unreasonable, the rentals would be adjusted to a reasonable amount by adjusting the profit or loss on the sale. Some respondents asked why the Statement requires sales with minor leasebacks to be accounted for based on the separate terms of the sale and of the leaseback but prohibits that same accounting for sales with more significant leasebacks.

11. To the extent that the seller-lessee's use of the asset sold continues after the sale, the sale-leaseback transaction is in substance a method of financing that continuing use, and no profit or loss should result from that transaction. To the extent that the seller-lessee gives up the right to the use of the asset sold, the transaction is in substance a sale, and profit or loss recognition might be appropriate; however, the extent of the seller-lessee's continuing use of the asset would have to be evaluated to determine whether that continuing involvement is so major that no profit should be recognized. Paragraph 107 of *FASB Statement No. 13* states the Board's conclusion that no means could be identified for separating the sale and the leaseback that would be both practical and objective. That conclusion was arrived at after considering comments received in response to an Exposure Draft on "Accounting for Leases." The Board has not modified that general conclusion. However, if the leaseback is minor, the overall sale-leaseback transaction clearly is in substance a sale of the property. The Board concluded that accounting for the sale and the leaseback based on their respective terms, using the reasonableness of the rentals as a control, is appropriate for a sale with a minor leaseback because it reflects the overall nature of the transaction. However, if the leaseback is more than a minor one, accounting for the sale and the leaseback based on their terms would permit the seller-lessee to recognize a profit on the portion of the transaction that is in substance a financing. Recognition of a sales-type profit on a financing would be equivalent to profit recognition on a company's sale to itself.

Therefore, the Board concluded that the terms of the sale and of the leaseback, using the reasonableness of the leaseback rentals as a control, should not be used as a basis for accounting for other sale-leaseback transactions.

**Definition of a "Minor" Leaseback**

12. Footnote+ indicates that a test based on the 90 percent criterion of *FASB Statement No. 13* could be used as a guideline to distinguish a "minor" leaseback. In that context, if the present value of the leaseback based on reasonable rentals is 10 percent or less of the fair value of the asset sold, the leaseback could be presumed to be minor. Some respondents suggested that "minor" be defined using a test based on the 75 percent of economic life criterion of Statement No. 13. In that context, if the leaseback encompassed less than 25 percent of the remaining economic life of the asset sold, the leaseback could be presumed to be minor.

13. Paragraph 75 of *FASB Statement No. 13* explains that 75 percent of economic life was considered to be substantially all of the benefits and risks incident to the ownership of the property because (a) new equipment, reflecting later technology and in prime condition, can be assumed to be more efficient, and hence yield proportionately more use benefit, than old equipment which has been subject to obsolescence and the wearing-out process, and (b) the present worth, at inception of the lease, of the last 25 percent of the remaining economic life of the property would represent less than 25 percent of the fair value of the asset at the inception of the lease. Both of those arguments indicate that the first 25 percent of an asset's economic life is more than a minor part of the asset's value. The Board decided to severely limit the minor leaseback exception from the usual sale-leaseback accounting, and accordingly, it used the 90 percent recovery criterion as a guideline to indicate the Board's intent for determination of a "minor" leaseback.

**Sales with Other Than "Minor" Leasebacks**

14. If a seller-lessee retains more than a minor part but less than substantially all of the use of an asset through a leaseback, this Statement requires the seller-lessee to recognize an amount of profit on the sale equal to the excess, if any, of the realized profit on the sale over the present value of the minimum lease payments (or the recorded amount of the leased asset if the leaseback is classified as a capital lease). Some respondents to the Exposure Draft suggested that the Board permit recognition of a pro rata portion of the realized profit on the sale for those sale-leaseback transactions, i.e., if the present value of the leaseback were equal to 60 percent of the fair value of the asset sold, 40 percent of the profit realized on the sale would be recognized, and the remaining 60 percent would be deferred and amortized over the leaseback term.

15. Paragraph 107 of *FASB Statement No. 13* states that the Board concluded that the present general requirement that gains and losses on sale-leaseback transactions be deferred and amortized should be retained. As discussed in paragraph 13 above, this Statement provides an exception for a minor leaseback because in that case the substance of the overall transaction is

apparent. For sales with leasebacks that are not minor, the Board decided to limit profit recognition to amounts that could not represent borrowings to be repaid. Thus, any profits up to the amount of the present value of the leaseback rentals (the maximum amount of borrowing that could be repaid) must be deferred and amortized. The recorded amount of the leased asset is usually the present value of the minimum lease payments. Accordingly, if the leaseback of part of the asset sold is classified as a capital lease, any profit on the sale up to the recorded amount of the leased asset must be deferred and amortized.

16. In the Exposure Draft, the Board proposed to limit recognition of profits on sales with other than minor leasebacks to the excess of the realized profit over the aggregate rental payments for an operating leaseback. Some respondents noted that the purchaser-lessor would expect to receive interest on any amount of sales proceeds that was in substance a borrowing; thus, the present value of those payments would be a more appropriate measure of the borrowing that could be repaid through leaseback rentals. The Board agreed with those respondents and modified this Statement to reflect their suggestion.

17. If the seller-lessee retains, through a leaseback, substantially all of the benefits and risks incident to the ownership of the property sold, the sale-leaseback transaction is merely a financing. The Board concluded that the seller-lessee should not recognize any profit on the sale of an asset if the substance of the sale-leaseback transaction is merely a financing. Accordingly, the Statement does not permit any profit to be recognized on a sale if a related leaseback *of the entire property sold* meets one of the criteria of *FASB Statement No. 13* for classification as a capital lease.

**Indicated Losses**

18. This Statement continues the requirement of *FASB Statement No. 13* that an indicated loss on the sale in a sale-leaseback be recognized up to the amount of the excess of the carrying amount of the asset sold over its fair value and does not permit an indicated loss on the sale in a sale-leaseback to be deferred and amortized as prepaid rent without some evidence that the indicated loss is in substance a prepayment of rent. If the fair value of the asset sold is more than its carrying amount, any indicated loss on the sale is probably in substance a prepayment of rent, and thus, deferral of that indicated loss to be amortized as prepaid rent would be appropriate.

**Amortization of Deferred Amounts**

19. Some respondents asked why the profit or loss that is deferred on the sale should be amortized over the period of expected use of the leased asset for an operating leaseback. They noted that any borrowing to be repaid through leaseback rentals would be repaid during the lease term, as defined in *FASB Statement No. 13,* to ensure recovery to the purchaser-lessor. Any reduction of sales proceeds that was in substance a prepayment of rent would result in bargain rentals during the affected period, and the lease term includes any option periods with bargain rentals. The Board agreed and modified paragraph 3 of this Statement to require that the amount

deferred or accrued be amortized over the lease term.

### Classification of Leasebacks

20. A few respondents asked whether special classification criteria should be provided for leasebacks. They suggested a criterion based on 90 percent recovery of the sales price called for by the related sale rather than 90 percent recovery of fair value of the leased asset. They also suggested that any deferred profit or loss be considered an adjustment of minimum lease payments for application of that criterion. This Statement addresses a narrow issue that was identified as a problem requiring urgent resolution. The Board concluded that it should not expand the scope of this Statement to provide special criteria for classification of a leaseback.

21. The Board concluded that on the basis of existing information it can make an informed decision on the matters addressed by this Statement without a public hearing and that the effective date and transition specified in paragraph 4 are advisable in the circumstances.

## Appendix B: ILLUSTRATIONS OF ACCOUNTING FOR SALES WITH LEASEBACKS

22. The examples in this Appendix illustrate the accounting for certain sales with leasebacks but do not encompass all possible circumstances. Accordingly, each situation should be resolved based on an evaluation of the facts, using the examples in this Appendix as guidance to the extent that they are applicable to the facts of the individual sale and leaseback.

### Minor Leaseback

23. An enterprise constructs a regional shopping center and sells it to a real estate management firm. The sale meets the criteria of the *AICPA Industry Accounting Guide,* "Accounting for Profit Recognition on Sales of Real Estate," for full and immediate profit recognition. At the same time, the seller leases back for 40 years a part of the facility, estimated to be approximately 8 percent of the total rental value of the center. Pertinent data are:

| | |
|---|---|
| Sales price | \$11,200,000 |
| Cost of shopping center | \$10,000,000 |

The rental called for by the lease appears to be reasonable in view of current market conditions. The seller-lessee would record the sale and recognize \$1,200,000 profit. The seller-lessee would account for the leaseback as though it were unrelated to the sale because the leaseback is minor as indicated in paragraph 3(a).

24. An enterprise sells real estate, consisting of land and a factory. The factory has an estimated remaining life of approximately 40 years. The sale meets the criteria of the *AICPA Industry Accounting Guide,* "Accounting for Profit Recognition on Sales of Real Estate," for full and immediate profit recognition. The seller negotiates a leaseback of the factory for one year because its new facilities are under construction and approximately one year will be required to complete the new facilities and relocate. Pertinent data are:

| | |
|---|---|
| Sales price | $20,000,000 |
| Carrying value of real estate | $ 6,000,000 |
| Annual rental under leaseback | $ 900,000 |
| Estimated annual market rental | $ 1,800,000 |

The leaseback is minor as indicated in paragraph 3(a) because the present value of the leaseback ($1,800,000) is less than 10 percent of the fair value of the asset sold (approximately $20,900,000, based on the sales price and the prepaid rental that apparently has reduced the sales price). Accordingly, the seller-lessee would record the sale and would recognize profit. An amount of $900,000 would be deferred and amortized as additional rent expense over the term of the leaseback to adjust the leaseback rentals to a reasonable amount.†† Accordingly, the seller-lessee would recognize $14,900,000 as profit on the sale ($14,000,000 of profit based on the terms of the sale increased by $900,000 to adjust the leaseback rentals to a reasonable amount).

**Leasebacks That Are Not Minor but Do Not Cover Substantially All of the Use of the Property Sold**

25. An enterprise sells an existing shopping center to a real estate management firm. The sale meets the criteria of the *AICPA Industry Accounting Guide,* "Accounting for Profit Recognition on Sales of Real Estate," for full and immediate profit recognition. At the same time, the seller leases back the "anchor" store (with corresponding use of the related land), estimated to be approximately 30 percent of the total rental value of the shopping center, for 20 years, which is substantially all of the remaining economic life of the building. Pertinent data are:

| | |
|---|---|
| Sales price of shopping center | $3,500,000 |
| Estimated to consist of: | |
| Land | $1,000,000 |
| Buildings and improvements | 2,500,000 |
| | $3,500,000 |
| Carrying value of shopping center | $1,000,000 |

| | |
|---|---|
| Monthly rentals called for by leaseback | $ 12,600 |
| *Seller-lessee's incremental borrowing rate | 10% |

The seller-lessee estimates the ratio of land to building for the leaseback to be the same as for the property as a whole. The seller-lessee would apply paragraph 26(b)(ii)(a) of *FASB Statement No. 13* because the land value exceeds 25 percent of the total fair value of the leased property and would account for the leaseback of the land as a separate operating lease. The seller-lessee would account for $2,500 as monthly land rental (10 percent annual rate applied to the $300,000 value of the land leased back—30 percent of the land value of the shopping center). The balance of the monthly rental ($10,100) would be allocated to the building and improvements and would be accounted for as a capital lease pursuant to the 75 percent of economic life criterion of Statement No. 13. The leased building and improvements would be recorded at the present value of the $10,100 monthly rentals for 20 years at the seller-lessee's 10 percent incremental borrowing rate, or $1,046,608. The seller-lessee would compute the profit to be recognized on the sale as follows:

| | | |
|---|---|---|
| Profit on the sale | | $2,500,000 |
| Recorded amount of leased asset (capital lease) | $1,046,608 | |
| Present value of operating lease rentals at 10% rate | 259,061 | |
| Profit to be deferred and amortized | | 1,305,669 |
| Profit to be recognized | | $1,194,331 |

The deferred profit would be amortized in relation to the separate segments of the lease. The amount attributable to the capital lease ($1,046,608) would be amortized in proportion to the amortization of the leased asset over the term of the lease. The amount attributable to the operating lease ($259,061) would be amortized on a straight line basis over the term of the lease.

26. An enterprise sells an airplane with an estimated remaining economic life of 10 years. At the same time, the seller leases back the airplane for three years. Pertinent data are:

| | |
|---|---|
| Sales price | $600,000 |
| Carrying value of airplane | $100,000 |
| Monthly rental under leaseback | $ 6,330 |
| *Interest rate implicit in the lease as computed by the lessor | 12% |

The leaseback does not meet any of the criteria for classification as a capital lease; hence, it would be classified as an operating lease. The seller-lessee would compute the profit to be recognized on the sale as follows:

| | |
|---|---|
| Profit on the sale | $500,000 |
| Present value of operating lease rentals ($6,330 for 36 months at 12%) | 190,581 |
| Profit to be recognized | $309,419 |

The $190,581 deferred profit would be amortized in equal monthly amounts over the lease term because the leaseback is classified as an operating lease.

**Leaseback That Covers Substantially All of the Use of Property Sold**

27. An enterprise sells equipment with an estimated remaining economic life of 15 years. At the same time, the seller leases back the equipment for 12 years. All profit on the sale would be deferred and amortized in relation to the amortization of the leased asset because the leaseback of *all* of the property sold covers a period in excess of 75 percent of the remaining economic life of the property, and thus, meets one of the criteria of *FASB Statement No. 13* for classification as a capital lease.

## Footnotes

FAS28, Par. 24, Footnote††--If the term of a prepayment of rent were significant, the amount deferred would be the amount required to adjust the rental to the market rental for an equivalent property if that rental were also prepaid.

FAS28, Par. 25, Footnote *--Believed to be approximately the same as the implicit rate calculated by the lessor.

FAS28, Appendix B, Footnote *--Used because it is lower than the lessee's incremental borrowing rate.