

Statement of Financial Accounting Standards No. 23

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Inception of the Lease

(an amendment of FASB Statement No. 13)

August 1978



Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 23: Inception of the Lease

an amendment of FASB Statement No. 13

FAS23 Summary

Under *FASB Statement No. 13*, "Accounting for Leases," the *inception of the lease* is the date on which the classification of a lease is determined. The lease is recorded at the beginning of the lease term using the classification that was determined at the date of the inception of the lease. If property covered by a lease is yet to be constructed or has not yet been acquired by the lessor at the date of the lease agreement or any earlier commitment, this Statement:

- Changes the "inception of the lease" from the date that construction is completed or the property is acquired by the lessor to the date of the lease agreement or any earlier commitment. This change is intended to result in a lease classification that more closely reflects the substance of the transactions.
- Changes the lessee's determination of "fair value of the leased property" for a lease with a cost-based or similar escalator provision from the amount estimated on the inception date to an amount that is escalated to give effect to increases under the escalator clause, when:
 - a. Fair value is used as a limitation on the amount of the asset to be recorded, or
 - b. Fair value is used as a basis for allocation of recorded amounts between land and buildings.

This change is intended to base the lessee's accounting on amounts that relate to the finally determined lease payments.

If the redefined "inception of the lease" is a date before the beginning of the lease term, with limited exceptions this Statement prohibits the recording of increases in estimated residual value that may occur between those two dates.

INTRODUCTION AND BACKGROUND INFORMATION

1. The FASB has been asked to reconsider the application of *FASB Statement No. 13*, "Accounting for Leases," for a leasing transaction in which the lessor and lessee agree on lease terms prior to the construction of the asset to be leased. Paragraph 2 describes circumstances in which a literal application of Statement No. 13 can result in a lease classification that does not reflect the economic considerations that entered into the agreement.

2. A lease that is, in effect, a financing transaction might be classified as an operating lease by both parties rather than as a capital lease to the lessee and a direct financing lease to the lessor. That classification would result from application of the 90 percent recovery criterion in *FASB Statement No. 13* at the date of completion of construction instead of the earlier date of the agreement or commitment. If the fair value of the leased asset increases during the construction period, it is possible that the present value of the minimum lease payments at the beginning of the lease term could be more than 90 percent of the estimated fair value of the leased asset at the earlier agreement date but less than 90 percent of the fair value of the leased asset at the later date that construction is completed. On the other hand, if the fair value of the leased asset decreases during the construction period, a lease that would otherwise have been classified as a direct financing lease by the lessor might meet the criteria for classification as a sales-type lease, requiring recognition of a loss even though the terms of the lease were designed to provide full recovery of cost and a reasonable rate of return on net investment to the lessor.

3. In view of the matters discussed above, the Board concluded that it should amend the definition of "inception of the lease" in *FASB Statement No. 13* to make it the date of the lease agreement or any earlier commitment in all cases. Previously, if a lease were for property to be constructed or to be acquired by the lessor, the "inception of the lease" would have been the date that construction was completed or the property was acquired by the lessor. The purpose of the change is to make the classification of a lease, which is determined at its inception date, better reflect the economic considerations that entered into the agreement. This Statement also amends two paragraphs of Statement No. 13 to provide that, if a lease has a cost-based or similar construction period escalator clause, "fair value at the inception of the lease," for purposes of the lessee's recording of the lease, is escalated to reflect any increases under that clause.

4. An Exposure Draft of a proposed Statement on "Accounting for Leases—Inception of the Lease" was issued on December 19, 1977. The Board received 30 letters of comment in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in Appendix A, "Summary of Consideration of Comments on Exposure Draft."

5. 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 11 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to FASB Statement No. 13

6. Paragraph 5(b) of *FASB Statement No. 13* is superseded by the following:

Inception of the lease. 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 provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

7. The following footnote is added to the end of the first sentence of paragraph 8(b) of *FASB Statement No. 13*:

If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at the inception of the lease, the classification criterion of paragraph 8(b) shall be applied at the date that construction of the property is completed or the property is acquired by the lessor.

8. The following footnote is added to the end of the second sentence of paragraph 10 of *FASB Statement No. 13* and to the end of the second sentence of paragraph 26(a)(i) of Statement No. 13:

If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or pre-acquisition period, the effect of any increases that have occurred shall be considered in the determination of "fair value of the leased property at the inception of the lease" for purposes of this paragraph.

9. Paragraphs 17(a) and 18(a) of *FASB Statement No. 13* are amended by adding the following final sentence and related footnote to each paragraph:

The estimated residual value used to compute the unguaranteed residual value accruing to the benefit of the lessor shall not exceed the amount estimated at the inception of the lease except as provided in footnote*.

*If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or pre-acquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of this paragraph.

10. Paragraph 43(c) of FASB Statement No. 13 is amended by adding the following final sentence and related footnote:

The estimated residual value shall not exceed the amount estimated at the inception of the lease except as provided in footnote⁺.

⁺If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or pre-acquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of this paragraph.

Effective Date and Transition

11. 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 December 1, 1978 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.

<p style="text-align: center;">The provisions of this Statement need not be applied to immaterial items.</p>

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

Donald J. Kirk, *Chairman*
Oscar S. Gellein
John W. March
Robert A. Morgan
David Mosso

Robert T. Sprouse
Ralph E. Walters

Appendix A: SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

12. The December 19, 1977 Exposure Draft proposed a complex amendment of the definition of *inception of the lease* in paragraph 5(b) of *FASB Statement No. 13*. The amended definition would have modified various determinations used for both classification of and accounting for a lease. The Exposure Draft also would have, in most cases, limited the amount recorded by the lessor for the residual value of the leased property to an amount not greater than the lessor's estimate as of inception of the lease.

13. Many respondents indicated that the proposed amendment was too complicated and requested clarification or simplification. Some respondents suggested that the Board separate lease classification from lease recording. Based on those comments, the Board made this final Statement a series of individual amendments that, in total, have approximately the same result as the Exposure Draft. The individual amendments are:

- a. The definition of *inception of the lease* in paragraph 5(b) of *FASB Statement No. 13* is amended to make it the date of the lease agreement or any earlier commitment. This modification should result in a lessee's classification of a lease that reflects the economic considerations that entered into the agreement.
- b. A footnote was added to paragraph 8(b) of Statement No. 13 to permit a lease of property that is to be constructed or acquired by the lessor to be classified as a sales-type lease or direct financing lease (providing it otherwise meets the criteria for those classifications) if there are no important uncertainties about unreimbursable costs yet to be incurred by the lessor at the date that the property is completed or acquired by the lessor, although there may have been such uncertainties at the inception of the lease. This modification and the modification described in paragraph 13(a) above, in combination, should result in a lessor's classification of a lease that reflects the economic considerations that entered into the agreement.
- c. Footnotes were added to paragraphs 10 and 26(a)(i) of Statement No. 13 to require a lessee to escalate the "fair value at the inception of the lease," used as a limitation for amounts to be recorded and as a basis for allocation between land and buildings in a real estate lease, for the effects of an escalator provision. The footnotes apply only to leases that include cost-based or similar construction period or preacquisition period escalator provisions.
- d. Paragraphs 9 and 10 of this Statement modify paragraphs 17(a), 18(a), and 43 of Statement No. 13 to limit the amount recorded by the lessor for the residual value of the leased property to an amount not greater than the estimate as of the inception of the lease. Footnotes were added to provide a limited exception to this requirement in the event that a

lease includes a cost-based or similar construction period or pre-acquisition period escalator provision.

- e. If a lease calls for adjustment of a lease provision because of specified changes occurring during a construction or pre-acquisition period, a new determination related to that occurrence may be appropriate if Statement No. 13 requires a determination at the inception of the lease for recording purposes. The Exposure Draft specified formula adjustments that would have applied to any lease provisions that call for adjustments. For simplicity, this Statement addresses only the usual cost-based or similar construction or pre-acquisition period escalator provisions (see paragraph 13(c) above). The parties to the lease should make the appropriate adjustments to record a lease if other types of construction period or pre-acquisition period contingency provisions are present. However, no adjustments should be made to reflect the effect of contingency provisions that continue during the lease term.

14. Some respondents questioned the application of the amended definition of inception of the lease to multiple "takedowns" of equipment under a master lease agreement. If a master lease agreement specifies that the lessee must take a minimum number of units or dollar value of equipment and if all other principal provisions are stated, the inception of the lease is the date of the master lease agreement with respect to the specified minimum. The inception of the lease for equipment "takedowns" in excess of the specified minimum is the date that the lessee orders the equipment because the lessee does not agree to lease the equipment until that date. To the extent that lease payments for required "takedowns" are based on value at the date of the "takedown," the lease, in effect, has a pre-acquisition period escalator provision based on value. Paragraphs 8-10 of this Statement address that situation. If a master lease agreement does not require the lessee to "takedown" any minimum quantity or dollar value of equipment, the agreement is merely an offer by the lessor to rent equipment at an agreed price and the inception of the lease is the date that the lessee orders the equipment.

15. Some respondents stated that retroactive application of the proposed Statement would require extensive recomputations to classify and account for existing leases and questioned whether the cost would be justified. Many respondents, on the other hand, stated that retroactive application of the amended definition in the proposed Statement was necessary to reflect the economic considerations that entered into existing leases. The Board considered the problems of data accumulation and reconsidered whether to require retroactive application or to permit prospective application of this Statement. Paragraphs 115-119 of *FASB Statement No. 13* discuss the considerations that resulted in the requirement for retroactive application of that Statement. The same considerations influenced the Board in its decision to adopt the transition requirements in this Statement. This Statement permits, but does not require, retroactive application for enterprises that have already applied Statement No. 13 retroactively *and* have published *annual* financial statements based on the retroactively adjusted accounts. All other enterprises are required to apply the provisions of this Statement retroactively at the same time as they apply the provisions of Statement No. 13 retroactively. Companies with a large number of leases that are affected may be able to use aggregate computations or statistical sampling techniques to compute the required adjustments.