

EITF ABSTRACTS

Issue No. 90-15

Title: Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions

[Nullified by FIN 46 and FIN 46(R) for entities within the scope of FIN 46 or FIN 46(R)]

Dates Discussed: July 12, 1990; September 7, 1990; November 8, 1990; January 10, 1991; July 11, 1991

References: FASB Statement No. 13, *Accounting for Leases*
FASB Statement No. 23, *Inception of the Lease*
FASB Statement No. 29, *Determining Contingent Rentals*
FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*
FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*
FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property*
FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*
FASB Staff Position FIN46-6, "Effective Date of FASB Interpretation No. 46"
AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*
AICPA Audit and Accounting Guide, *Audits of Investment Companies*
SEC Staff Accounting Bulletin No. 57, *Views concerning Accounting for Contingent Warrants in Connection with Sales Agreements with Certain Major Customers*

ISSUE

A company (lessee) enters into a lease that has been designed to qualify as an operating lease under Statement 13, as amended; however, certain characteristics of the lease have raised questions as to whether operating lease classification is appropriate:

1. Lessee residual value guarantees and participations in both risks and rewards associated with ownership of the leased property

2. Purchase options
3. Special-purpose entity (SPE) lessor that lacks economic substance
4. Property constructed to lessee's specifications
5. Lease payments adjusted for final construction costs.

The issue is whether either operating lease treatment or another method of accounting is appropriate for leases with all or some of the characteristics described above.

EITF DISCUSSION

The Task Force reached a consensus that a lessee is required to consolidate a special-purpose entity lessor when all of the following conditions exist:

1. Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee
2. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through such means as
 - a. The lease agreement
 - b. A residual value guarantee through, for example, the assumption of first dollar of loss provisions [Note: See STATUS section.]
 - c. A guarantee of the SPE's debt
 - d. An option granting the lessee a right to (1) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or (2) receive any of the lessor's sales proceeds in excess of a stipulated amount
3. The owner(s) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease. [Note: This consensus has been nullified by Interpretation 46 and Interpretation 46(R). See STATUS section.]

If the above conditions exist, the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the lessee's financial statements. This conclusion should be applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet the aforementioned conditions. [Note: This consensus has been nullified by Interpretation 46 and Interpretation 46(R). See STATUS section.] In those cases, the consolidation by the lessee should begin at the inception of the lease, as defined in Statement 13 and amended in Statement 23, rather than the beginning of the lease term.

A lease containing the general characteristics described in the issue above that does not meet conditions for consolidation noted above, may qualify for operating lease treatment. However, it was noted that it is necessary to evaluate the facts and circumstances of each lease in relation to the requirements of Statement 13, as amended, to determine the appropriate lease classification. In particular, the Task Force noted that determining the existence of an economic penalty that results in reasonable assurance of the lessee's renewal of the lease beyond the initial lease term must be assessed based on the facts and circumstances of each lease.

At the July 11, 1991 meeting, the Task Force Chairman announced that he had received a letter from the acting Chief Accountant of the SEC outlining the SEC staff position on a number of recent implementation questions relating to this issue. Those questions and the SEC staff responses are as follows:

Question No. 1

Did the EITF consensus resolve the SEC staff's concerns with respect to the leasing transactions discussed in various SEC staff announcements in EITF minutes?

Response

The SEC staff believes the consensus, along with appropriate disclosures, provides timely guidance with respect to certain leasing transactions involving SPEs that were of the most concern to the SEC staff. These included sale-leaseback transactions involving personal property, real property when the property is built to the lessee's specifications, and property meeting the specifications of the lessee that is purchased by the lessor.

All leasing transactions should be carefully analyzed, particularly those including any potential penalties or involving special-purpose property, in accordance with Statement 13, as amended. Registrants' disclosures should include a general description of the leasing arrangements as required by paragraph 16(d) of Statement 13. The SEC staff believes such disclosures should

include the significant terms of leasing arrangements, including renewal or purchase options, escalation clauses, obligations with respect to refinancing of the lessor's debt, significant penalties (as defined in Statement 98), and the provisions of any significant guarantees, such as residual value guarantees.

In addition, Financial Reporting Codification Section 501, *Management's Discussion and Analysis*, requires disclosure of any known demands, commitments, events, or uncertainties that will result in or that are reasonably likely to have a material impact (or for which management cannot make such determination) on the registrant's liquidity, capital resources, or income from continuing operations or would cause reported financial information not to be indicative of future operating results or of future financial condition. In addition, Article 5 of Regulation S-X requires disclosure of all material commitments and contingent liabilities.

Question No. 2

Is the guidance in Issue 90-15 applicable to SPEs utilized in transactions other than those specified in the consensus?

Response

The Working Group (which was specifically formed to work with the SEC staff to study this issue and propose a consensus to the Task Force) only considered the SPE issue as it relates to leasing transactions. These transactions may vary significantly from other types of SPE transactions in structure and in terms of risks and rewards. Accordingly, the consensus did not include nonleasing transactions in its scope.

The views expressed by the SEC staff at the February and May 1989 EITF meetings are still applicable to SPE transactions other than those addressed by Issue 90-15. The SEC staff notes that the conditions identified in Issue 90-15 are consistent with the views on SPEs previously expressed by the SEC staff. The Issue 90-15 conditions focus on the risks and rewards and substantive nature

of the SPE, which are critical to consolidation. Accordingly, the conditions set forth in Issue 90-15 may be useful in evaluating other transactions involving SPEs.

The SEC staff would expect to resolve these other nonleasing transactions on a case-by-case approach. Consistent with SAB Topic 5K (SAB 57), the SEC staff recommends that registrants discuss such unusual transactions with the SEC staff on a pre-filing basis.

Question No. 3

What is meant in the consensus by the term *expected substantive residual risks*? Does it mean the 90 percent threshold specified in paragraph 7(d) of Statement 13?

What amount qualifies as a substantive residual equity capital investment (condition (3) of the consensus)?

Response

In these transactions, the significant elements of management and control over the leased asset generally are specified by contract when the lease is negotiated and the SPE is established. Certain of these elements of management and control raise concerns on the part of the SEC staff with respect to who possesses the risks and rewards of ownership of the leased asset. These include elements such as a nonsubstantive lessor without equity at risk, a lessee who has the ability to realize all appreciation and bears substantial risk of depreciation, and a lessee who acts as the construction agent and selling agent and who is at more than nominal risk. In determining if a registrant has substantive residual risks and rewards of the leased asset (condition (2) of the consensus), the SEC staff would review a transaction to determine if the lessee has these or similar elements of management and control. If the lessee would reasonably be expected to bear the substantive residual risks and receive rewards due to such elements, the SEC staff would consider condition (2) to be met. This would be a judgmental decision based on the specific facts and

circumstances of each transaction, and does not involve the 90 percent determination as set forth in Statement 13.

The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. [Note: The consensus in this Issue has been nullified by Interpretation 46 and Interpretation 46(R). See STATUS section.] The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed.

As the consensus states, the investment should be at risk with respect to the leased asset for the entire term of the lease. The investment would not be considered to be at risk, for example, if the investor were provided a letter of credit or other form of guarantee on the initial investment or return thereon. An investor note payable issued to the SPE would not qualify as an initial substantive residual equity investment at risk.

Question No. 4

If the initial substantive residual equity capital is reduced below the minimum amount required because of losses recorded by the SPE in accordance with generally accepted accounting principles (GAAP), is the investor required to make an additional capital investment?

Response

The SEC staff understands that the Working Group discussed this question and concluded that the answer is no.

Question No. 5

May the investor withdraw its initial minimum required equity investment prior to the expiration of the lease term?

Response

There may be circumstances in which an investor makes an investment in excess of the minimum required equity investment. In those circumstances, the investor may withdraw its initial investment in excess of the minimum required equity. However, the EITF included in condition (3) of the consensus, a requirement that the initial minimum equity investment be at risk during the entire term of the lease. Accordingly, that minimum amount could not be withdrawn either directly or indirectly. The SEC staff understands that the Working Group believed that transactions would include documentation that would enable the lessee to determine the lessor had maintained its capital at risk.

Question No. 6

If an SPE contained a building whose value increased such that the equity of the SPE increased on an appraised fair value basis, could the investor withdraw its initial capital to the extent of the increase in the fair value of the property?

Response

No. Condition (3) requires the initial investment to be at risk during the entire term of the lease. As noted in Question 4 above, the minimum investment is not required to be increased for GAAP losses and it is not permitted to be withdrawn for appraisal increases.

Question No. 7

Does the consensus apply to previous transactions within its scope?

Response

EITF consensuses are applied on a prospective basis unless a consensus specifically addresses transition. Accordingly, the SEC staff believes the guidance in the consensus should be applied on a prospective basis to the transactions within its scope.

The SEC staff has made various announcements regarding leasing transactions that have been included in the EITF meeting minutes. These announcements focused on the same issues as the conditions in Issue 90-15, but were more general in nature. Registrants should have followed the guidance in the announcements and the SEC staff's prior position as set forth therein, when filing financial statements that include material leasing transactions involving an SPE and that were completed prior to January 10, 1991 (the date of the consensus).

Question No. 8

If a previously formed SPE has an existing lease in it and has not been consolidated (for example, due to immateriality or because it would not have required consolidation pursuant to the SEC staff announcements or Issue 90-15), and if a new lease is put in the SPE so that the SPE meets the conditions in Issue 90-15 for consolidation, can only the new lease be consolidated on a pro rata basis? Since the SPE was formed prior to the consensus, is the SPE and any future transactions it participates in grandfathered?

Response

The SEC staff does not permit pro rata consolidation except in limited circumstances (those specifically provided for in the authoritative literature), which do not include a leasing SPE. Neither the SPE nor its future transactions would be considered to be grandfathered, and accordingly, the entire SPE should be consolidated on a prospective basis.

Question No. 9

May an existing nonsubstantive SPE become a substantive entity by having an investor put in sufficient capital to meet condition (3) of the consensus and accordingly be unconsolidated?

Response

Yes. However, if an investor puts in additional capital, it may result in changes in the lease terms, including perhaps the lease payments. The SEC staff believes a lease entered into with a consolidated SPE, which is then unconsolidated when a substantive equity investment is made, is analogous to a sale-leaseback transaction and results in a new lease that should be assessed pursuant to the conditions of Issue 90-15 at the time the changes are made. [Note: The consensus in this Issue has been nullified by Interpretation 46 and Interpretation 46(R). See STATUS section.] The lessee would also need to evaluate the lease in accordance with Statement 13, as amended, and Statement 98 for transactions within its scope.

The SEC staff would apply the same guidance when an existing nonsubstantive SPE enters into significant substantive leases with other unrelated lessees and accordingly no longer meets condition (1) of the consensus.

STATUS

A related issue was discussed in Issue No. 96-20, “Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities.” That Issue was nullified by Statement 140, which replaced Statement 125, in September 2000. Under Statement 140, a qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates. Other aspects of this consensus were not affected by the issuance of Statement 140. [Note: See STATUS section of Issue 96-20 for details.]

Issue No. 96-21, “Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities,” provides responses to several additional questions that relate specifically

to conditions (1) and (3) of Issue 90-15. The questions relate to the following issues: multiple properties within a single SPE-lessor, multi-tiered SPE structures, payments made by lessee prior to beginning of lease term, payments to equity owners of an SPE during the lease term, fees paid to owners of record of an SPE, source of initial minimum equity investment, equity capital at risk, payment to owners of record of an SPE prior to the lease term, costs incurred by lessee prior to entering into a lease agreement, and interest-only payments.

Another related issue was discussed in Issue No. 97-1, “Implementation Issues in Accounting for Lease Transactions, including Those Involving Special-Purpose Entities.” The categories of issues are: (1) environmental risk, (2) non-performance-related default covenants, and (3) depreciation. Categories (1) and (2) apply to leasing transactions irrespective of whether the lessor is an SPE. Category (3) applies when the lessor is an SPE. (See Issue 97-1 for details of the consensuses reached.)

Interpretation 45, which was issued in November 2002, requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee. The Interpretation also elaborates on the disclosures to be made by a guarantor. If a lease is classified as an operating lease, the lessee may have to recognize a liability at inception of the lease if it provides a guarantee that meets any of the characteristics found in paragraph 3 of that Interpretation. In addition, such a guarantee would be subject to that Interpretation’s disclosure requirements. Interpretation 45 does not impact any of the consensuses reached in this Issue.

Interpretation 46 and Interpretation 46(R) nullify the consensuses in this Issue for entities within the scope of the applicable Interpretation. If a lessor entity is a variable interest entity as described in Interpretation 46 or Interpretation 46(R), it is subject to consolidation based on the provisions of the applicable Interpretation. If a lessor entity is not a variable interest entity, it is subject to the requirements of ARB 51 as amended by Statement 94.

Interpretation 46 was issued in January 2003. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply to all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established.

FSP FIN46-6 deferred the effective date for applying the provisions of Interpretation 46 for:

1. Interests held by a public entity in variable interest entities created before February 1, 2003, if the public entity has not issued financial statements reporting that interest in accordance with Interpretation 46. The application of Interpretation 46 to those interests is deferred until the end of the first period ending after December 15, 2003.
2. Nonregistered investment companies accounting for their investments in accordance with the specialized accounting guidance in the investment company Guide.

Interpretation 46(R) was issued on December 24, 2003, and replaced Interpretation 46. An enterprise with an interest in an entity to which the provisions of Interpretation 46 were not applied as of December 24, 2003, must apply the effective date and transitions provisions in Interpretation 46(R) to that entity. Application by public companies of Interpretation 46 or Interpretation 46(R) to entities commonly referred to as special-purpose entities is required no later than as of the end of the first reporting period that ends after December 15, 2003. Public enterprises must apply Interpretation 46(R) to all entities no later than the end of the first reporting period that ends after March 15, 2004 (public enterprises other than small business issuers) or December 15, 2004 (small business issuers). Nonpublic enterprises must apply Interpretation 46(R) to entities created after December 31, 2003, immediately and to all other entities by the beginning of the first annual period beginning after December 15, 2004. An enterprise that has applied Interpretation 46 to an entity prior to the effective date of Interpretation 46(R) shall either continue to apply Interpretation 46 until the effective date of Interpretation 46(R) or apply Interpretation 46(R) at an earlier date.

No further EITF discussion is planned.