

Statement of Financial Accounting Standards No. 27

[FAS27 Status Page](#)
[FAS27 Summary](#)

Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases

(an amendment of FASB Statement No. 13)

May 1979



Financial Accounting Standards Board
of the Financial Accounting Foundation
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CONTENTS

	Paragraph Numbers
Introduction and Background Information.....	1–5
Standards of Financial Accounting and Reporting:	
Amendments to FASB Statement No. 13.....	6–8
Effective Date and Transition.....	9

FAS 27: Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases

an amendment of FASB Statement No. 13

FAS 27 Summary

This Statement modifies *FASB Statement No. 13*, "Accounting for Leases," to require a lessor to classify a renewal or an extension of a sales-type or direct financing lease as a sales-type lease if the lease would otherwise qualify as a sales-type lease and the renewal or extension occurs at or near the end of the lease term. If the renewal or extension occurs at other times during the lease term, the prohibition in Statement No. 13 against classifying the renewal or extension as a sales-type lease continues in effect. Furthermore, this Statement does not affect the classification of a lease that results from a change in the provisions of an existing lease or the accounting for changes in the provisions of a lease if those changes occur during the lease term.

INTRODUCTION AND BACKGROUND INFORMATION

1. The FASB has been asked to reconsider the provision of paragraph 6(b)(i) of *FASB Statement No. 13*, "Accounting for Leases," that states "a renewal or an extension⁹ 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." According to footnote 9 to paragraph 6(b)(i), a renewal or extension includes a new lease under which the lessee continues to use the same property. If the provisions of a sales-type or direct financing lease are changed, the revised agreement might be considered a new agreement under the provisions of paragraph 9 of Statement No. 13.

2. Those making the request described above stated that leases that have the same characteristics are classified and accounted for differently because of the prohibition in paragraph 6(b)(i) of *FASB Statement No. 13*. They noted that the prohibition against classifying a renewal or extension of an existing sales-type or direct financing lease is only applicable if the original lease was classified as a sales-type or direct financing lease and the same lessee

continues to use the leased property. On the other hand, the prohibition is not applicable if the original lease was classified as an operating lease or if the property is leased to a different lessee. In their opinion, different lease classification and accounting should not be based on the identity of the lessee or the classification of an original or existing lease.

3. An Exposure Draft of a proposed Statement on "Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases" was issued for public comment on February 13, 1979. The Board received 25 letters of comment in response to the Exposure Draft.

4. The Exposure Draft made a distinction between renewals or extensions of existing sales-type or direct financing leases that occur during the lease term and those that occur at or near the end of the lease term. Several respondents stated that the timing of a renewal or an extension of an existing sales-type or direct financing lease should not affect the classification or the accounting for a revised or extended lease. They suggested completely eliminating the prohibition against recording a "second sale" for renewals or extensions of existing sales-type or direct financing leases. The Board considered that alternative but concluded that the prohibition against recording a "second sale" should continue if a renewal or extension occurs *during the term* of a lease. In limited circumstances, *FASB Statement No. 13* recognizes "partial sales" of leased property. In accounting for a sales-type lease, a "partial sale" is recognized by including only the present value of the minimum lease payments in "sales" revenue and excluding the present value of the unguaranteed residual value from the cost of the leased property charged against that revenue. Recognition of "partial sales" under Statement No. 13 is a liberalization of prior practice in accounting for leases, which did not permit recognition of "partial sales." This Statement extends those limited circumstances to certain renewals or extensions of existing sales-type or direct financing leases that occur at or near the end of the lease term. A further extension of those circumstances to permit recognition of a "partial sale" for a renewal or extension that occurs during the term of an existing lease would require significant modifications to many of the accounting and reporting provisions of Statement No. 13, and the Board does not believe that problem warrants the additional effort that would be required.

5. The Board has concluded that it can reach an informed decision on the basis of existing data without a public hearing and that the effective date and transition specified in paragraph 9 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to FASB Statement No. 13

6. The last sentence of paragraph 6(b)(i) of *FASB Statement No. 13* is superseded by the following:

A renewal or extension⁹ of an existing sales-type or direct financing lease that otherwise qualifies as a sales-type lease shall be classified as a direct financing lease unless the renewal or extension occurs at or near the end of the original term* specified in the existing lease, in which case it shall be classified as a sales-type lease. (See paragraph 17(f).)

*A renewal or extension that occurs in the last few months of an existing lease is considered to have occurred at or near the end of the existing lease term.

7. The third sentence of paragraph 6(b)(ii) of *FASB Statement No. 13* is superseded by the following sentence:

An exception arises when an existing sales-type or direct financing lease is renewed or extended¹⁰ during the term of the existing lease.

8. The following subparagraph is added to paragraph 17(f)(ii) of *FASB Statement No. 13*:

c. If a renewal or extension that occurs at or near the end of the term⁺ of the existing lease is classified as a sales-type lease, the renewal or extension shall be accounted for as a sales-type lease.

⁺See footnote*.

Effective Date and Transition

9. The provisions of this amendment to *FASB Statement No. 13* shall be effective for lease agreement renewals and extensions (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 affirmative votes of six members of the Financial Accounting Standards Board. Mr. Walters dissented.

Mr. Walters dissents to this amendment because, while it properly removes one inconsistency in accounting for similar transactions, it substitutes another inconsistency based solely on timing. If one accepts that a transaction styled as a lease that does not transfer title is substantively a sale, one necessarily accepts the notion of a partial sale; that is, a sale of something less than all the rights to a property for all of its economic life. If one can sell a portion of the whole, one can also sell a portion or all of the remainder, and the accounting for a transaction that meets the criteria of a sale should not differ based solely on its proximity to the end of the original lease term.

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