



Manufacturer Recourse: Revenue Recognition Issues

It's important to understand relevant accounting rules.

Leasing is a tool utilized by many manufacturers to increase product sales. A vendor-leasing company purchases equipment directly from the manufacturer and, in turn, provides lease financing to the manufacturer's customers. In certain circumstances a vendor-leasing company is not willing to provide lease financing to the customer without a guarantee, such as credit or residual support, from the manufacturer. A manufacturer's ability to recognize a profit on the equipment sale depends on the nature and size of these guarantees.

FASB's and the SEC's directives touch on a common theme: continuing involvement from the seller may, based on the nature of the involvement, preclude revenue recognition on the sale.



Revenue Recognition

According to the guidance set forth in FASB Concept Statement No. 5 "Recognition and Measurement in Financial Statements of Business Enterprises," revenue is recognized when 1) realized or realizable and 2) earned. A manufacturer must have substantially completed the earnings process to be entitled to the benefits represented by the revenues. The earning process is not complete if the seller has substantial continued involvement in a transaction. Depending on the type and degree of support provided, manufacturer recourse in the form of credit or residual guarantees may represent a substantial continuing involvement in the transaction.

In Staff Accounting Bulletin 101 (SAB 101), the Securities and Exchange Commission (SEC) further determined that revenue is generally realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists,
- Delivery has occurred or services have been rendered,
- The seller's price to the buyer is fixed or determinable,
- Collectibility is reasonably assured

The SEC discusses situations where the substance of the transaction is not a sale but a consignment or financing; therefore, persuasive evidence of an arrangement does not exist. An example is a transaction containing a provision allowing the buyer to return the product and requiring the seller to significantly assist with resale efforts. Under these circumstances, the seller retains significant risks and rewards of ownership and revenue recognition may not be appropriate.

The Financial Accounting Standards Board (FASB) has provided direction with regards to revenue recognition for returnable merchandise. In accordance with SFAS 48 "Revenue Recognition When Right of Return Exists," when a buyer has the right to return merchandise purchased, the seller may not recognize income from the sale, unless all of the following conditions are met:

- The seller's price to the buyer is substantially fixed or determinable at the date of sale.
- The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
- The buyer's obligation to the seller would not be

changed in the event of theft or physical destruction or damage of the product.

- The buyer acquiring the product for resale has economic substance apart from that provided by the seller.

- The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.

- The amount of future returns can be reasonably estimated.

The directives set forth by the FASB and the SEC touch on a common theme: continuing involvement from the seller may, based on the nature of the involvement, preclude revenue recognition on the sale.

Operating Lease Agreements

More specific guidance on manufacturer recourse and its impact on accounting treatment can be found in paragraph 21 of SFAS 13 "Accounting for Leases," which states that:

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 manufacturer may sell equipment to a vendor-leasing company and agree to support the underlying credit or residual value in order to protect the leasing company's return on the investment. If the lease agreement between the vendor-leasing company and the lessee is accounted for as an operating lease in accordance with SFAS 13 and the seller retains substantial risks of ownership, then the manufacturer is unable to treat the transaction as a sale. The four basic criteria for classifying a lease under paragraph 7 of SFAS13 are as follows:

- The lease transfers ownership of the property to the lessee by the end of the lease term

- The lease contains a bargain purchase option

- The lease term is equal to 75 percent or more of the estimated economic life of the leased property

- The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property.

If a transaction between the lessee and the vendor-leasing company (lessor) passes any one of these tests, and, in addition, collectibility of the minimum lease payments is reasonably predictable and no important uncertainties surround the amount of unreimbursable costs to be incurred by the lessor, the lease is a direct financing or sales-type lease. A sales-type lease is a transaction that not only

passes one of the four tests shown above but also gives rise to manufacturer's or dealer's profit or loss to the lessor. If none of the above criteria are met in the transaction between the lessee and the vendor-leasing company, then the lease is classified as operating for accounting purposes. Additionally, the manufacturer will not qualify for sale treatment if substantial risks of ownership are retained. SFAS 13 provides the following as an example of substantial risks of ownership

In the case of default by the lessee or termination of the lease, the seller is committed to a) acquire the lease or the property, b) substitute an existing lease, or c) secure a replacement lessee or buyer for the property under a remarketing agreement.

In late 1999, at an AICPA Conference on Current SEC Developments, the SEC indicated that they consider a direct or indirect guarantee of lease payments another form of risk of ownership for purposes of interpreting the guidance in paragraph 21 of SFAS 13. As such, if the amount of the credit and residual guarantee is substantial, the transaction should be accounted for as a borrowing instead of a sale. Substantial risk

The accounting guidelines prohibit recognition of a sale in situations where the seller has substantial continuing involvement in the subsequent lease transaction.

is generally measured as risk that equals or exceeds 10 percent, on a present value basis, of the fair value of the equipment at the time of the equipment's initial transfer.

The proper recording of a transaction where the underlying lease is an operating lease and the seller, or a related entity, retains substantial risk of ownership is to account for the transaction not as a sale, but as a borrowing, with the equipment recorded as an operating lease.

An underlying lease that is classified as a finance or sales-type lease agreement by definition passes the risks and rewards of ownership to the lessee, so the manufacturer is not precluded from recognizing revenue regardless of whether the vendor-leasing company is a related entity. This is the case even if the seller or manufacturer provides credit, residual or other forms of support to the vendor leasing company.

If the seller/manufacturer cannot determine at the time of the sale how the vendor leasing company will lease the property to end-users, the seller is required to assume that the leases will be operating leases.

EITF 95-1

“Revenue Recognition on Sales with a Guaranteed Minimum Resale Value” is covered in the Emerging Issues Task Force Issue #95-1 (EITF 95-1). This EITF addresses the accounting for a transaction where the manufacturer sells equipment to an end

user and contractually guarantees that the purchaser will receive a minimum resale amount at the time of equipment disposition. The manufacturer agrees to either (1) reacquire the equipment at a guaranteed price at specified time periods as a means to facilitate its resale or (2) pay the purchaser for any deficiency between the sales proceeds received for the equipment and the guaranteed minimum resale value. The task force concluded the following:

A manufacturer is precluded from recognizing a sale of equipment if the manufacturer guarantees the resale value of the equipment to the purchaser. Rather, the manufacturer should account for the transaction as either an operating or sales-type lease, using the principles of lease accounting in SFAS 13.

The findings in EITF 95-1 are consistent with FASB 13 in that the manufacturer cannot recognize a sale if the company has retained substantial risks of ownership. The manufacturer must record the transaction as a sales-type lease or an operating lease. In the event that the transaction is classified as an operating lease, the manufacturer's net proceeds received on the transfer of the equipment are recorded as a liability. The liability is then reduced on a pro-rata basis, over the period from the equipment initial transfer date to the first exercise date of the guarantee, to the amount of the guaranteed residual. The corresponding credits are recognized as revenue.

EITF 95-4

EITF 95-4, "Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease," discusses revenue recognition on products sold to dealers. The EITF focused

on whether a sale could be recognized if a manufacturer sold equipment to a dealer and then the manufacturer, or its captive subsidiary, provides financing, in the form of an operating lease, to the end-user. EITF 95-4 stated that if all the following conditions exist, the manufacturer would not

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be precluded from recognizing a sale at the time the product is transferred to the dealer:

The dealer is a substantive and independent enterprise that transacts business separately with the manufacturer and customers.

The manufacturer has delivered the product to the dealer, and the risks and rewards of ownership have passed to the dealer, including responsibility for the ultimate sale of the product. A customer's failure to enter into a lease with the finance affiliate (or manufacturer) would not allow the dealer to return the product to the manufacturer.

The finance affiliate (or manufacturer) has no legal obligation to provide a lease arrangement to a potential customer of the dealer at the time the product is delivered to the dealer.

The customer has other financing alternatives available from parties unaffiliated with the manufacturer, and the customer is in control of the selection from the financing alternatives.

If all four of these conditions exist, the manufacturer has not retained substantial risks of ownership and, therefore, can recognize a sale of the equipment.

Revenue Recognition on Transactions with Manufacturer's Recourse

As previously stated, the accounting guidelines prohibit recognition of a sale in situations where the seller has substantial continuing involvement in the subsequent lease transaction. The existence of credit or residual guarantees, provided by a manufacturer to a vendor-leasing company purchasing its products, can negatively impact the amount of revenue recognized at the time of the initial equipment transfer. If the manufacturer, through its offering of credit or residual guarantees, is deemed to have retained substantial risks of ownership, then sale treatment cannot be taken. The initial equipment transfer is treated as an operating or a sales-type lease based on how the transaction is classified

under SFAS 13. The guidelines suggest that if the present value of the manufacturer's total maximum risk of loss on a transaction is more than 10 percent of the fair value of the equipment at the time of the equipment's initial transfer, then operating lease accounting treatment is appropriate and profit on the sale is deferred.

For a variety of reasons, manufacturers periodically group individual transactions into a pool and sell this group of leases to a funding source. The funding source, typically a vendor-leasing company, may require additional credit or residual support in order to realize an adequate return on investment. This type of pooling arrangement brings up questions regarding when a manufacturer can recognize revenue on the underlying lease transactions.

For example, assume that a manufacturer sells a pool of two leases with one investment grade credit and one non-investment grade credit to a vendor-leasing company. In addition, the manufacturer provides credit support for a maximum risk of loss of 9.9 percent. Since this portfolio does not contain homogeneous transactions, it can be viewed that the manufacturer stands to lose up to 19.8 percent on the non-investment grade credit and 0 percent on the investment grade credit. Therefore, the manufacturer could not recognize a sale and must defer the profit on the non-investment grade transaction, as the present value of the maximum risk of loss is more than 10 percent on this lease. The accounting community has offered differing interpretations on how to handle manufacturer revenue recognition on recourse pools. The prevailing thought is that the manufacturer's maximum risk of loss can be assessed at the pool level rather than the individual lease level on homogeneous pools of transactions. A homogeneous pool may exist, for example, if the sale of assets occur over a short period (i.e. one quarter), the assets have similar residual values and the leases are for similar terms. However, due to the potential diversity in interpretation on what constitutes homogeneous recourse pools, it is recommended that each company discuss the nature of its guarantees and recourse pools with their auditors.

In some instances, a manufacturer may participate in residual sharing with the vendor-leasing company in exchange for remarketing the equipment at end of lease. According to SFAS 13, 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.

Accounting for Guarantees: Existing Transactions Exempt from Balance Sheet Reporting Requirement

The FASB has completed its redeliberations on the guarantee project and expects to issue the final version of the *Interpretation of Statements Nos. 5, 57, and 107 for Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* during the fourth quarter of 2002. All existing guarantees and non-performance related indemnities will require financial statement disclosures that identify the maximum exposures and related pertinent details for financial statements issued subsequent to December 15, 2002. Further, the fair value of the guarantees and indemnities must be reported as liabilities for those transactions entered into subsequent to December 31, 2002. All existing transactions as of December 31, 2002 will not be subject to balance sheet reporting, but will need to be disclosed. The balance sheet reporting is likely to be required for financial reporting periods commencing after March 20, 2002.

While the disclosure requirement is consistent with existing guidance on residual value guarantees, the balance sheet reporting requirement represent a fundamental change to accounting for residual value guarantees that have a less than probable expectation of resulting in a loss. It is unlikely that the final interpretation will provide specific guidance on the methodology to be used to measure guarantees that lack market valuation data or specific guidance on the method and timing of the offsetting entries. FAS Concept Statement #7 provides some incite into the methodology to be used to estimate the value of the guarantee based upon a present value of future possible losses.

The offsetting entries that are required in order to record the liability are not defined. At issue is whether and when any entries are required to the income statement as well as whether and when the liability should be remeasured. These issues are likely to be addressed only by the Big 4 accounting firms. **ELT**

—Patricia Donoghue, BTM Capital Corporation, Boston

Recent Developments

On May 22, 2002, the FASB issued an exposure draft on “Proposed Interpretations on Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.” This interpretation has implications on the accounting for manufacturer guarantees, as a guarantee on an operating lease would have to be booked at its fair value on the balance sheet. Refer to the side bar article for additional information on this exposure draft.

On May 15, 2002, the FASB added a project to develop a statement of financial accounting standards on revenue recognition to its technical agenda. FASB expects the project to take two years to complete, with the result being a new comprehensive accounting standard on revenue recognition that would also amend the related guidance on revenues and liabilities. According to the FASB, the statement would a) eliminate the inconsistencies in the existing authoritative literature and accepted practices, b) fill the voids that have emerged in revenue recognition guidance in recent years, and c) provide guidance for addressing issues that arise in the future.

ELA will continue to provide updates on the progress of these projects on its website at elaonline.com. **ELT**

ELT thanks Deborah Brady, Key Equipment Finance for this month's column.