

Case 91-6

Sale of an Asset Subject to an Operating Lease

Lease & Sail, Inc. (the Company) owns and leases the 15 sailboats in its fleet to corporate customers, generally, for five-year terms. The Company accounts for the leases as operating leases and reports the sailboats at acquisition cost in its balance sheet.

Because the Company needs cash in order to add some new sailboats to its fleet, it decided to sell five of its sailboats, which are subject to operating leases. The acquisition cost of the sailboats was \$2.6 million, but because they were part of a limited edition, their fair value at the date of the transaction is \$3.1 million.

Lease & Sail has transferred its title and interest in the sailboats as well as the leases to the buyer, PCI Financing, in exchange for \$450,000 in cash and the assumption by PCI of \$1.8 million of the Company's obligations. Simultaneously with this transaction, Lease & Sail and PCI also entered into a management agreement (the Agreement) under which the Company will have the following management responsibilities:

- To maintain relations with the lessees
- To monitor the lessees' performance of their obligations on the leases
- To bill lessees for lease payments
- To maintain the sailboats

Under the Agreement, the Company will receive a fee of \$34,000 for arranging the transaction. However, the Agreement is silent as to how much the Company will be paid to perform its management responsibilities.

In addition, the Company will be required to use the personnel in its marketing department to provide assistance to PCI in remarketing the sailboats when the leases have expired. At that time, Lease & Sail will also inspect the sailboats, make recommendations as to their possible upgrading and refurbishing, negotiate with potential subsequent buyers, and obtain remarketing approval from PCI.

If the remarketing produces a "realized amount" as defined by the Agreement, the company will be compensated for its remarketing services in an amount equal to 15% of Lease & Sail's original cost to purchase the sailboats after PCI has received an amount equal to 23.5% of the Company's original purchase price. Thereafter, the "realized amount" will be distributed equally between the Company and PCI.

Lease & Sail plans to account for this transaction as a sale and plans to record \$725,000 as an asset, which the Company believes is its interest in the estimated residual value of the sailboats on remarketing. Lease & Sail's management also believes the Company should recognize a net gain of \$375,000 on the transaction. The residual value has been estimated based on an outside appraisal, which was discounted to eliminate the effects of inflation, but not discounted to reflect the time value of money. The Company also plans to recognize the \$34,000 fee as income.

Required:

- What is the substance of this transaction?
- Is the Company's interest in the residual value an asset?
- Has the Company realized a gain on the transaction?
- What should be the timing of revenue recognition on the management agreement?
- What should be considered in deciding whether Lease & Sail should record the transaction as a sale?