

REGULATION, RENTS AND RESIDUALS

The FASB statement on leases is unnecessarily complex and has several major flaws as well.

by John W. Coughlan

Everybody except the landlord seems to want to regulate rents. Even the Financial Accounting Standards Board has gotten into the act by regulating the manner of accounting for rents. In FASB Statement no. 13, *Accounting for Leases*,¹ the FASB proposes the

¹ Financial Accounting Standards Board Statement no. 13, *Accounting for Leases* (Stamford, Conn.: Financial Accounting Standards Board, November 1976), employs the term "capital lease" from the lessee's perspective only. For the lessor, it divides capital leases into "sales-type leases" and "direct financing leases." Since there is no comment here about the distinction between sales and financing leases, and since both correspond to what from the lessee's perspective is referred to as a capital lease, the term capital lease will be used for both lessee and lessor. The purpose of this article is to probe the basic flaws in the capital vs. operating distinction; therefore, the extension of these flaws to sales, financing and leveraged leases will not be discussed. Likewise, the concern will be the quilt (Statement no. 13) rather than the patches (FASB Statements nos. 17, *Accounting for Leases—Initial Direct Costs*; 22, *Changes in the Provisions of Lease Agreements Resulting From Refundings of Tax-Exempt Debt*; 23, *Inception of the Lease*; 26, *Profit Recognition on Sales-Type Leases of Real Estate*; 27, *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases*; 28, *Accounting for Sales With Leasebacks*; and 29, *Determining Contingent Rentals*; and FASB Interpretations nos. 19, *Lessee Guarantee of the Residual Value of Leased Property*; 21, *Accounting for Leases in a Business Combination*; 23, *Leases of Certain Property Owned by a Governmental Unit or Authority*; 24, *Leases Involving Only Part of a Building*; 26, *Accounting for Purchase of a Leased Asset by the Lessee During the Term of the Lease*; and 27, *Accounting for a Loss on a Sublease*). It must be obvious that any quilt which requires 13 patches in three years must be rent beyond repair. In mid-January the FASB announced plans to issue this year a single pronouncement that would integrate Statement no. 13 and all the amendments and interpretations of that statement.

following "basic concept" in distinguishing between "capital leases" and "operating leases":

"... a lease that transfers substantially all of the benefits and risks . . . should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase . . ." (paragraph 60).

The distinction is one of common sense; since corporate controllers and accounting practitioners are traditionally blessed with this commodity, there would have been no problem in applying this "rewards and risks" distinction.

Statement no. 13 did not stop here, however. It imposed additional criteria purportedly to assist in applying the basic concept. In doing so, it created a complex² document with fundamental flaws that go to the very essence of the distinction:

- It introduces two criteria—(a) and (b)—that are clearly implicit in another criterion—(d)—and are therefore redundant.
- It introduces a rate for discounting purposes—the "incremental borrowing rate"—in circumstances in which it is unlikely the rate can ever be used but expresses faith that it is this rate which will "generally" be used for the lessee's accounting for capital leases.

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² For a good analysis of some of the complexities of Statement no. 13, see Raymond J. Clay, Jr., and William W. Holder, "A Practitioner's Guide to Accounting for Leases," *JofA*, Aug. 77, pp. 61-68. See also J. Kenneth Alderman and C. Wayne Alderman, "Accounting for Leases," *JofA*, June 79, pp. 74-79.

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Its excessive regulatory zeal leads to arbitrary distinctions capable, for example, of putting two almost identical lessors (say, two "rent a car" companies) in different industrial classifications, one renting machinery (operating leases) and the other making loans (capital leases).

The Lessor's Criteria

The lessor shall treat as a capital lease—that is, shall interpret as a lease involving a sale or financing event—any lease that meets both of the following two requirements (pars. 7 and 8):

- It must meet any one of four criteria, which are designated (a), (b), (c) and (d).
- There must be no important uncertainties about certain future cash flows.

The first requirement is an "or" proposition; it is enough if a lease meets any of the four criteria. However, it can easily be demonstrated that, if criterion (d) belongs on the list, there is no need for (a) or (b).

Criterion (d)

It is no exaggeration to say that everything in the first test turns on criterion (d):

"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 . . . to the lessor at the inception of the lease. . . . A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease . . ." (par. 7).

Example 1. A lessor leases an automobile with a fair value of \$5,000 at \$135 per month for 30 months, with the initial payment to occur at inception. At the end of 30 months, the lessee is to return the car, the lessor is to sell it and the lessee guarantees it will be worth \$2,000 at that time. If it sells for less than \$2,000, the lessee will make up the difference. The \$2,000 is referred to as a "guaranteed residual value." Criterion (d) requires that the minimum lease payments—which include the guaranteed residual—be discounted by use of the "interest rate implicit in the lease," which is 1 percent per month compounded monthly, as shown in exhibit 1, this page. The example is drawn from Appendix C of Statement no. 13, which points out that the present value of the minimum lease payments is \$5,000 and that it is 100 percent of fair value. Is it a coincidence the present value works out to exactly 100 percent rather than 98 percent or 103 percent?

It is no happenstance; it is no coincidence.

Exhibit 1

Illustration of criterion (d)

| | <i>Minimum lease payments</i> | × | <i>Discount factors</i> | = | <i>Present values</i> |
|----------|---------------------------------------|---|-----------------------------|---|---------------------------|
| Month 1 | \$ 135 | × | $1/(1.01)^0$ | = | \$ 135 |
| Month 2 | 135 | × | $1/(1.01)^1$ | = | 134 |
| Month 30 | 135 | × | $1/(1.01)^{29}$ | = | 101 |
| Month 31 | 2,000 | × | $1/(1.01)^{30}$ | = | 1,483 |
| Totals | <u>\$6,050</u> | | | | <u>\$5,000</u> |

It is a consequence of the definition of the interest rate implicit in the lease. This rate discounts the minimum lease payments to the fair value of the property at the inception of the lease. In the example, the interest rate implicit in the lease is i in equation 1, as follows:

Equation 1

$$5,000 = 135/(1+i)^0 + 135/(1+i)^1 + \dots + 135/(1+i)^{29} + 2000/(1+i)^{30}$$

In solving this equation for i , it will be found that the implicit rate is approximately .01 in decimal form or 1 percent per month.

The present value computed by means of this implicit rate is exactly 100 percent of fair value because we are locked in a circle. The implicit rate is that rate which equates the present value of the minimum lease payments to the fair value at the inception of the lease. If the minimum lease payments are then discounted by this implicit rate, it should be no surprise that their present value is exactly equal to the fair value. What is involved is two applications of the above equation 1; in the first application, the \$5,000 is treated as known and the accountant solves for the unknown i , finding it to be 1 percent; in the second, the 1 percent is known and employed to discount the minimum lease payments to the unknown present value, which—surely to nobody's surprise—turns out to be the same \$5,000 with which the accountant began!

Were there nothing else than what has been described, all leases without exception would meet criterion (d), O. J. Simpson sprinting through the airport would have to tarry with the complexities of capital leases and Statement no. 13 would be nonsense. However, there is "something else"—the "unguaranteed residual value" (URV), defined as the estimated residual value of the

leased property at the end of the lease exclusive of any portion guaranteed by the lessee. Statement no. 13 defines the interest rate implicit in the lease as follows:

"The discount rate that, when applied to (i) the minimum lease payments . . . and (ii) the unguaranteed residual value . . . accruing to the benefit of the lessor, causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property . . . to the lessor at the inception of the lease . . ." (par. 5(k)).

Example 2. Assume the same lease except that now, while it is reasonable to suppose that the auto will be worth \$2,000 after 30 months, the lessee makes no guarantee concerning residual value, which accordingly becomes a URV. From the quotation above, it is apparent that the URV is included in the determination of the implicit interest rate so that it is the same 1 percent per month that solves equation 1, with the discounted values appearing as follows: $5,000 = 3,517^* + 1,483$.

The term with the asterisk is the present value of the minimum lease payments, and the final term is the present value of the URV. While the URV plays a role in the determination of the implicit rate, it is not included in the present value used in criterion (d). Indeed, it is the presence of the URV in the implicit rate definition and its absence from (d) that saves Statement no. 13 from a vicious circle. Since the present value of the minimum lease payments to be used in (d)—the asterisked 3,517—is less than 90 percent of the 5,000 fair value, (d) is not met and the lease is an operating lease. The important thing to notice is that the present value is other than 100 percent of fair value. This can only happen within the Statement no. 13 framework if there is a URV. Furthermore, it is only if this URV is substantial in relation to the minimum lease payments that criterion (d) can be failed.

The Redundancy of Criteria (a) and (b)

The redundancy of criteria (a) and (b) can now be seen. Criterion (a) states: "The lease transfers ownership of the property to the lessee by the end of the lease. . . ." While the leased property may have some residual

value at termination, it can have none accruing to the lessor. Any lease meeting (a)—that is, transferring ownership by the end of the lease term—will have no URV to the lessor, and the implicit rate, no matter what the fair value and the minimum lease payments, will always discount minimum lease payments to exactly 100 percent of fair value. A lease that meets (a) must meet (d).

Criterion (b) states: "The lease contains a bargain purchase option." Since the bargain purchase option is included in minimum lease payments and title is assumed to pass, there can be no URV accruing to the lessor, and the lease must have a present value of 100 percent of fair value and thereby meets (d).

If either (a) or (b) is met, by definition alone, there can be no URV to the lessor and (d) must be met. Since requirement 1 is met if one of the four lettered criteria is met, there is no need to check (a) or (b) if (d) is met. A list that includes (d) has no need for (a) or (b).

Criterion (c)

It would be convenient if it could be demonstrated that leases meeting criterion (c)—". . . lease term . . . is equal to 75 percent or more of the estimated economic life of the leased property . . ."—automatically meet (d). Unfortunately, it is possible (but difficult) to construct examples to the contrary.

Nevertheless, for the sake of simplicity, (c) should be eliminated for the very good reason that the great majority of leases that meet (c) also meet (d). Bear in mind that URV for a lease covering 75 percent or more of economic life will, because of the partial obsolescence of the asset and its need for greater maintenance, be small and the present value of that URV will be but a small part of the value at inception. (Indeed, paragraph 75 of Statement no. 13 so states.) Accordingly, it is apparent that, because of the circle previously cited, almost all leases meeting (c) meet (d) and, therefore, (c) may on practical grounds also be considered redundant.

A Simplified Criterion

The first requirement for a capital lease from the lessor's viewpoint—namely, that it meet one or more of the lettered criteria—has now been condensed into the single criterion (d). In so condensing, it is recognized that there are a few leases that meet (c) (just barely)

and nevertheless fail (d) (just barely). It is further recognized that there are no leases that meet (a) or (b) that do not meet (d). Can the retention of (a) to (c) be justified because a lack of knowledge might make it impossible to apply (d)? Suppose, for example, the lessor could not determine fair value and could not, therefore, apply (d). But any assistance that (a), (b) or (c) would provide in such a case would be nugatory. Statement no. 13's prescribed lessor accounting for capital leases requires a knowledge of the implicit rate, which in turn requires a knowledge of the same fair value and cash flow information that is required to apply (d). If the criterion (d) information is not available, there is no point using (a) to (c) to determine the operating or capital character of a lease since the information needed to account for a capital lease is also not available.

The Statement no. 13 requirements for a capital lease may accordingly be simplified by dropping (a), (b) and (c) and by using only (d) or its shadow, the URV, so that the lessor's two requirements may be stated as follows:

- The URV must be small or nominal.³
- There must be no important uncertainties about certain future cash flows.

In a quest for an even more concise statement of the capital lease requirement, return to the URV and ask why it should make a difference. Consider any lease, such as the one in example 2, with a sufficiently large URV to fail criterion (d) and be classified as an operating lease. Now let the lessee guarantee the residual value as in example 1; recalling the circle, the present value will be 100 percent of fair value and the lease will meet (d) and will be classified as a capital lease. While the total to be received is identical—at least on an expected value basis—more of it is guaranteed. A guarantee of residual value is sufficient to convert all operating leases to capital leases.

Apparently the Statement no. 13 view is that there is no problem accounting for the lease payments as a long-term receivable with appropriate recognition of interest in-

come if there is little uncertainty about cash flows and some assurance that the lessor will recover his investment and earn a positive interest rate, whereas important elements of uncertainty pertaining to the future cash flows—particularly if there is some doubt about the ability to fully recover the fair value of the leased asset—should lead to the operating classification. Seen from this perspective, it is risk and uncertainty—the natural human tendency to fear the dark—that is the enemy of the capital lease. The simplified two-point criterion suggested above might be further condensed since both points deal with uncertainties about future cash flows. One could replace the two-point test with a one-point test relating to the subjective probability of recovering the fair value of the leased property and (possibly) some positive amount of interest:

Capital leases are those for which there is at least an X probability of recovering the fair value of the leased asset.

One hopes that the practitioner would be permitted to rely on his judgment to pick the probability (it might be stated in terms of a reasonable expectation), but the FASB could (and undoubtedly would) prescribe a probability. Such a simplified test (if passed) would in all likelihood lead to the same leases being classified as capital leases as those using the Statement no. 13 criteria and (if failed) would lead to the same leases being classified as operating leases as those using the statement's criteria. Where the classifications of particular leases differed, the difference would generally result from arbitrary consequences of the overly complex criteria in Statement no. 13 rather than from differences in the underlying purposes.

The Incremental Borrowing Rate

Turning to the lessee, a curious aspect of Statement no. 13 is the introduction of a new interest rate—"the incremental borrowing rate"—which may play some role in the classification scheme but cannot play any role (despite the statement's suggestions to the contrary) in the accounting.

The lessee's incremental borrowing rate is defined as the "rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset" (par. 5(1)). Following is another version of criterion (d) that includes certain wording omitted in the excerpt printed on page 59.

"The present value at the beginning of the lease term of the minimum lease payments

³ This approach is similar to that in a statement of position issued by the accounting standards division of the American Institute of CPAs, which did not specify an exact percentage but, instead, suggested capitalization when the residual value was expected to be "nominal" (JofA, Oct.75, p.14 and Dec.75, p.26).

... equals or exceeds 90 percent of ... the fair value of the leased property ... to the lessor. ... A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate ... unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate" (par. 7(d)).

Assuming the lessee knows the implicit rate,⁴ it can be demonstrated that the implicit rate will always be employed in the accounting whether it is higher or lower than the incremental borrowing rate. Suppose first the

⁴ Surely a reasonable assumption despite Statement no. 13's suggestion to the contrary in the above excerpt of (d). All that is needed to infer the implicit rate are three items of information: the minimum lease payments, the URV and the fair value of the leased property to the lessor at the inception of the lease. Since the minimum lease payments are the principal subject matter of the lease agreement, presumably the lessee knows as much about them as the lessor.

Possibly the lessor knows more about URV than the lessee. Recall from the previous analysis, however, that the URV cannot be too great if the lease is classified as a capital lease. Given that the lessee is correct in classifying a lease as a capital lease, it follows that the URV will not be too substantial and it is therefore unlikely that the lessee's estimate can be sufficiently erroneous to make a material difference to his computation of the implicit rate.

This leaves the fair value of the leased property to the lessor at the inception of the lease. Much of the personalty (office equipment, computers, fleets of trucks, etc.) to which Statement no. 13 is currently being applied has a well-established purchase price that is readily available to the lessee; to the extent it is not, antitrust efforts at the federal level are increasingly making it available. Accordingly, it may be concluded that, for most of the leased property to which Statement no. 13 is currently applied, the lessee may make almost as good an estimate of the implicit rate as the lessor. The FASB also appears to believe that the lessee can infer within limits that implicit rate; since the first draft of this article was written, the FASB has issued an exposure draft of a proposed statement requiring the lessee in certain circumstances to make a "reasonable estimate" of the implicit rate.

Even in those rare cases in which no reasonable estimate of the implicit rate can be made, the conclusion in this article—that the incremental borrowing rate will never be used—still stands. Admittedly, with regard to certain personalty and some realty, usually with perpetual life, the lessor may have better information with regard to fair value. But it still cannot be inferred that the incremental borrowing rate will play a role because the lessee's ignorance of fair value will prevent application of the all-important criterion (d), the 90-percent-of-fair-value test! Such leases rarely meet criterion (a) or (b) and usually cannot meet (c). The ignorance of fair value prevents the lessee not only from knowing the implicit rate but also from classifying the lease as a capital lease and having an opportunity to use the incremental borrowing rate.

implicit rate is less than the incremental borrowing rate⁵ so that, following the above quotation, the implicit rate is used for classification purposes in criterion (d). The implicit rate will also be used for the accounting. *The incremental borrowing rate plays no role.*

Now suppose the incremental borrowing rate is lower. From the above quotation, it is apparent this incremental rate will be employed to test criterion (d); if the test is met, one might assume, other things being equal, that the incremental borrowing rate would play a role in the accounting. But here is a key passage:

"The lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments. . . . *However, if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value.* . . . The discount rate to be used in determining present value of the minimum lease payments shall be that prescribed for the lessee in paragraph 7(d)" (par. 10, emphasis supplied).

If there is no URV, the present value as discounted by the implicit rate is exactly 100 percent of fair value. Since it is now hypothesized that the incremental borrowing rate is less than the implicit rate, it is apparent that the similar present value using the lower incremental borrowing rate will exceed 100 percent of fair value. Observing the italicized limitation to fair value in the above quotation, it seems obvious that the lessee will capitalize the fair value, which is based on the implicit rate, not the incremental rate; the other prescriptions in Statement no. 13 (particularly paragraph 12) make it apparent that it is the implicit rate which will be used in all subsequent accounting. *The incremental borrowing rate still plays no role in the accounting.*

The best illustration is example 1, but this time regarded from the lessee's viewpoint. This example is straight from Statement no. 13, which specifies that while the implicit rate is 1 percent per month the incremental borrowing rate is only .875 per-

⁵ There are good reasons to think the implicit rate will be less. Statement no. 13 treats capital transactions as being, in part at least, credit transactions, and the mere fact that the lessee in effect "borrows" from the lessor rather than from his next best source of credit (the incremental borrowing rate) would suggest the lessor's interest rate—the implicit rate—is lower.

cent per month. The present value using this lower incremental borrowing rate is \$5,120 which, as observed in Statement no. 13, exceeds the fair value of \$5,000. The illustration of lessee accounting in the statement accordingly involves a capitalization of the fair value of \$5,000 (which implies use of the implicit rate, not the incremental borrowing rate), and the subsequent entries are based throughout on the implicit rate. When there is no URV or only a small one, the present value using the lower incremental borrowing rate will exceed fair value and the incremental borrowing rate cannot play a role.

Even if there is a substantial URV (see the appendix, page 64, for a detailed analysis), the conclusion still stands: *the incremental borrowing rate can play no role in the accounting.*

Unfortunately, this analysis cannot be reconciled with the explicit assumption in Statement no. 13 that the lessee will "generally" use the incremental borrowing rate:

"With respect to the rate of interest to be used in determining the present value of the minimum lease payments for recording the asset and obligation under a capital lease, the Board concluded the rate should generally be that which the lessee would have incurred to borrow for a similar term the funds necessary to purchase the leased asset (the lessee's incremental borrowing rate)" (par. 93).

May one conclude that the architects of the labyrinth also get lost in its corridors?

Third-Party Guarantors

It has been demonstrated that there is only one interest rate in Statement no. 13, the implicit rate, and it was previously demonstrated that, using this implicit rate, only (d) of the lettered criteria need be tested. Recalling that criterion (d) is always met and that all leases are capital leases unless there is a URV, it is to be hoped that no excess of regulatory zeal, and no desire to specify everything, has led the FASB to make any mistakes in the concept or definition of this central concept of URV.

Example 3A. Hurts Rent-A-Car leases automobiles on a daily basis. The rental fee for a day, net of certain executory costs (such as maintenance), is \$51. Hurts does not insure these cars since it serves as its own insurance company. An auto has a fair value of \$5,000 when rented, and Hurts anticipates it will be worth \$5,000 when returned 24 hours later. The lessee pays the \$51 when he returns the auto. By solving the following equation for i

$$5,000 = 5,051 / (1 + i)$$

it will be found that the implicit rate is approximately 1 percent per day compounded daily. The minimum lease payment is \$51; if this amount is discounted one day at 1 percent, it will have a present value of \$50, which is far below 90 percent of the fair value, or \$4,500. Accordingly, (d) is not

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If its 'economic consequence' is a better allocation of scarce resources, then it needs no authority."

met, the lease will be classified as an operating one, the auto will remain on Hurts's books (where it will be depreciated) and the \$51 will be recognized as rental revenues.

Example 3B. Mavis Rent-A-Car owns title to autos, hands keys to its customers and employs maintenance mechanics, but these peripherals are simply a clever "cover" for its real business, which is making one-day loans at usurious interest rates. Mavis keeps only \$50 of each daily rental fee and requires the lessee to use the other \$1 to buy a contract with an independent insurance company, which guarantees the auto will be worth \$5,000 when returned. Since the cash flow expectations are approximately the same as for Hurts, Mavis will compute the implicit rate in the same fashion and will discover the implicit rate to be 1 percent per day. But, since the definition of URV states that it is the estimated residual value of the leased property "exclusive of any portion guaranteed by the lessee or by a third party unrelated to the lessor" (par. 5(i), emphasis supplied), the Mavis \$5,000 is a guaranteed residual; as such it is an integral part of the minimum lease payments since such payments include "any guarantee of the residual value . . . by a third party

unrelated to either the lessee or the lessor, provided the third party is financially capable of discharging the obligations that may arise from the guarantee" (par. 5(j)ii). Now test criterion (d) by discounting the minimum lease payments—the full \$5,050—at the implicit rate of 1 percent:

$$5,050/1.01 = 5,000$$

Since there is no URV, it is not surprising that the present value is exactly 100 percent of fair value but, since (d) is met, it may come as a considerable shock to Mavis to find it is in the short-term loan business rather than in auto leasing. Lapses in logic and obfuscating complexities aside, can there be merit to a pronouncement that puts Hurts in car renting and Mavis in loan sharking?

Accounting and Authority

The tale of two leases, the operating lease and the capital lease, is neither the best nor the worst of FASB statements. Surely its emphasis on future cash flows and on present values, while foreshadowed to some extent in prior pronouncements (notably Accounting Principles Board Opinions nos. 21, *Interest on Receivables and Payables*; 5, *Reporting of Leases in Financial Statements of Lessee*; 7, *Accounting for Leases in Financial Statements of Lessors*; 27, *Accounting for Lease Transactions by Manufacturer or Dealer Lessor*; and 31, *Disclosure of Lease Commitments by Lessees*), must be counted among its more positive and forward-looking developments.⁶ Just as surely, its implicit belief that accounting requires authority, and authority of a complex and stifling character, must constitute its most negative and backward-looking features.

In matters of social interaction, where differences of opinion must be resolved in some manner, authority in the form of laws, legislatures, judges and juries may be necessary. If accounting falls in this arena—and there is a growing opinion that it does as witness the existence of the FASB and the Cost Accounting Standards Board—the path ahead is clear. There will be an increasing amount of regulation, and it will be imposed with the muscle of the federal government. The official pronouncements will have the full force of law but will follow the model

so carefully set since 1935 by the committee on accounting procedure of the American Institute of Accountants (a predecessor of the AICPA), the APB and the FASB. These official pronouncements will differ in no important respect from their predecessors except that they may be more voluminous and more costly. One hopes that there is a better road.

Usefulness—not authority—is the final arbiter of accounting. If its “economic consequence” is a better allocation of scarce resources, then it needs no authority. If it does not perform a useful function in that sense, then no authority will help.⁷

Appendix

It was shown in the accompanying article that if there is no URV, or only a small one, then the incremental borrowing rate is completely irrelevant to the accounting. It will be demonstrated in this appendix that, even with a substantial URV, there is little possibility that the incremental borrowing rate can play any role in the accounting.

Observe first that a substantial URV usually leads to the lease's being classified as an operating lease and therefore provides no opportunity to employ the incremental borrowing rate (see example 2, page 60).

What is required is a URV that is small enough to permit the lease to meet criterion (d) but, at the same time, large enough so that, using the lower incremental borrowing rate, the present value will be less than fair value. (Otherwise fair value and the implicit interest rate will be employed.) Whether such a small-enough, large-enough URV is even possible depends on the meaning of “fair value.”

Example 4. The lessee acquires the use of an asset with a five-year life by making rental payments of \$1,000 per year at the beginning of each of the first three years. At the beginning of the fourth, with two years of

⁷ See also John W. Coughlan, *Guide to Contemporary Theory of Accounts* (Englewood Cliffs, N.J.: Prentice-Hall, 1965), p.1, and Accounting Principles Board Statement no. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (New York: AICPA, 1970), par. 21.

⁶ Also see a research study that has had much to do with the development of thought regarding leases: John H. Myers, Accounting Research Study no. 4, *Reporting of Leases in Financial Statements* (New York: AICPA, 1962).

life to go, the asset reverts to the lessor, at which date it is expected to be worth \$471, its URV. The lessee's incremental borrowing rate is 10 percent and, assuming the asset has a fair value to the lessor at the inception of the lease of \$2,800, the implicit rate is 20 percent; as shown in exhibit 2, below.

Exhibit 2

Two Interpretations of "Fair Value"

| | Present values | | |
|-------------------------------------|----------------|---------|------|
| | at 10% | at 20% | |
| 1,000 | \$1,000 | \$1,000 | |
| 900 | 909 | 833 | |
| 800 | 827 | 694 | |
| Minimum lease payments | \$2,736 | 2,527 | FV B |
| Unguaranteed residual value (\$471) | | 273 | |
| Total | | \$2,800 | FV A |

Statement no. 13 is unambiguous regarding the application of (d) in this situation. The lessee would use his incremental borrowing rate and the appropriate present value is accordingly \$2,736 from the above tabulation. Criterion (d) requires that this present value equal or exceed 90 percent of the "fair value . . . to the lessor . . ." (emphasis supplied). That fair value to the lessor would include the present value of the URV and would accordingly be the \$2,800 in the tabulation. Clearly the \$2,736 using the incremental borrowing rate exceeds 90 percent of fair value, and Statement no. 13 would require capitalization. So far there's no problem, and the incremental borrowing rate has played a role in the classification scheme.

But now turn to the accounting and consider Statement no. 13's limitation in paragraph 10 (see page 62) of the amount capitalized to the fair value. Two interpretations of fair value are possible, and both lead to problems for Statement no. 13:

□ If the fair value limitation refers to fair value to the lessor (the \$2,800 labeled "FV A" in the tabulation), the same fair value that is used in criterion (d) for classification purposes would be employed in the accounting, and the amount capitalized would be the \$2,736 from the tabulation; this is less than FV A of \$2,800, and the subsequent accounting would indeed be based on 10 percent, the incremental borrowing rate. But now observe that because the URV must be not great (for fear of failing (d)), the difference in the amount capitalized as between

using the two interest rates is trivial. Further, while the interest rates (10 percent vs. 20 percent) differ considerably, an exploration of the net effect on the income statement in the ensuing years should convince the reader that, if both interest expense and depreciation are considered, the net impact on the income statement is negligible. The incremental borrowing rate, if appropriate at all, gives results that cannot differ much from the implicit rate; therefore, the accountant who wants to simplify Statement no. 13 may employ the implicit rate in all cases and, if ever called to account, may simply quote the boldface sentence that appears in all FASB statements, including no. 13: "The provisions of this Statement need not be applied to immaterial items." Even allowing for this interpretation, it may be concluded that *the incremental borrowing rate can play no material role in the accounting.*

But this interpretation is difficult to allow. To arrive at such a result, one must include in fair value the present value of the URV. While URV may be relevant to the lessee's classification of a lease as operating or capital, and criterion (d) so implies, it is hardly conceivable that URV can have any relevance to the subsequent accounting for leases classified as capital leases. In deciding whether a lease is operating or capital, it may make sense for the lessee to inquire whether he acquires the full service potential of the leased asset or whether there is a substantial URV that reverts to the lessor. But in limiting the capitalized present value to fair value, it makes little sense to include in the limitation the present value of the unguaranteed residual, a residual that goes to the lessor and that is surely irrelevant to the lessee except possibly for classification purposes.

□ It is far more meaningful to interpret paragraph 10 in terms of the fair value relating to the service potential acquired by the lessee. While Statement no. 13, in defining the implicit rate (paragraph 5 (k)), specifies fair value to the lessor and again, in stating criterion (d), refers to the lessor, its paragraph 10 limitation is in the discussion of lessee accounting and omits the crucial

words "to the lessor" even though the term "fair value" is used twice: "... if the amount so determined exceeds the fair value of the leased property at the inception of the lease, the amount recorded as the asset and obligation shall be the fair value." To make sense out of this fair value limitation, it must surely be fair value to the lessee.

But this fair value to the lessee is simply the present value of the minimum lease payments discounted by the implicit rate. It is the \$2,527 labeled "FV B" in the tabulation. Since it is hypothesized throughout this appendix that the incremental borrowing rate

is lower than the implicit rate, the present value using the lower incremental borrowing rate will always be higher than that using the implicit rate; therefore, the fair value limitation must always be binding and that fair value will be capitalized and amortized by use of the implicit rate, not the incremental borrowing rate. *Given that the implicit rate is known, the incremental borrowing rate can never play any role in the accounting.* ■

The problem in measuring social performance

Whatever problems there might be in "measuring" social performance, there can be little doubt, at least, that an independent view of a company's operations will be both truer and fairer than any account a company would be likely to prepare on its own and about itself. But of course the measurement of social performance, and even the presentation of data, will present problems—possibly the least of which will arise in translating figures into words. Thus, to the numerate, the figure 70 percent means just that: 70 percent. But it may otherwise legitimately be expressed as "a substantial majority"; "by no means all"; "over two out of three"; or "under three out of four." It is a figure which may be above or below some legal or other requirement; better or worse than the figure achieved by an organization's competitors; and it may refer to some relatively trivial aspect of an organization's performance—or to a crucial one. . . .

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