

# Is Lessee Accounting Working?

In practice the rules for capitalizing leases are ineffective. The author gives interesting examples of abuse of the rules in the present situation, the circumstances that led to this situation, and proposes a solution for the confusion.

**W**HILE the objectives of FASB Statement 13 "Accounting for Leases" appear meritorious, the arbitrary rules, sub-rules, subsequent interpretations and amendments (both official and unofficial) for implementing these objectives have created substantial problems for the independent CPA and for financial management. This article analyzes many of the implementation problems; offers reasons why they have arisen; and finally suggests a solution to the dilemma, primarily with respect to accounting for leases by lessees.

The objective of Statement 13, as described in its Appendix (Basis for Conclusions) was that:

A lease that transfers substantially all of the benefits and risks incident to the ownership of property 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.

The Board believed that Statement 13 would remove most "if not all, of the conceptual differences in lease classification as between lessors and lessees and that it provides criteria for such classification that are more explicit and less susceptible to varied interpretation than those in previous literature."

Based on actual results of Statement 13 for over two years, its objectives and the assertion of "less susceptibility to varied interpretation" have not been reached. In fact, there continues to be a significant number of long-term leases that pass substantially all risks and rewards of ownership of property to the lessee and yet continue to be accounted for as operating leases. In addition, while drafters of new leases may have to sharpen their pencils a bit, it is common to find agreements negotiated that

provide a finance lease for the lessor and an operating lease for the lessee.

## Statement No. 13—An Overview

In studying the lease classification rules of Statement 13, one quickly concludes that the major stumbling block to noncapitalization is in overcoming the test of paragraph 7d. While this paragraph represents only one of four distinct tests that, if met, requires a lessee to capitalize a lease, it is the only new rule that is, in most instances, quantifiable. This rule, commonly referred to as the 90 percent recovery test, requires a lessee to capitalize a lease if the present value, at the beginning of the lease term, of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the leased property over any related investment tax credit retained by the lessor and expected to be realized by him.

The other lessee capitalization rules, referred to in paragraphs 7a, b and c of Statement 13 are not significant hurdles to overcome. For example, paragraphs 7a and 7b require a lessee to capitalize a lease if "the lease transfers ownership of the property to the lessee by the end of the lease term" or if "the lease contains a bargain purchase option." Both of these tests are substantially unchanged from APB Opinion No. 5 and, except for possible varying interpretation of what constitutes a bargain purchase option, few, if any, leases not capitalized under APB Opinion No. 5 (of which there were very few) would not be capitalized under these rules of Statement 13.

The test in paragraph 7c of Statement 13 is also similar to the underlying thrust of APB Opinion No. 5; however, it does differ in that Statement 13 is more specific. It provides that if the lease term (as defined) equals or exceeds 75 percent of the estimated economic life of the leased property, the lessee is required to capitalize the lease. Most practitioners realize that estimates of useful lives of assets are judgmental and, if an estimate is within a given range, they are not apt to object. Accordingly, a building lease of 30 years will commonly not be required to be capitalized under paragraph 7c, because arguments that a building life often exceeds 40 years is easily sus-

---

*Richard Dieter, CPA, is an audit partner in the Boston office of Arthur Andersen & Co. He is a member of the AICPA and the Massachusetts Society of CPAs, and is a member of the AICPA task force on off-balance sheet financing.*

---

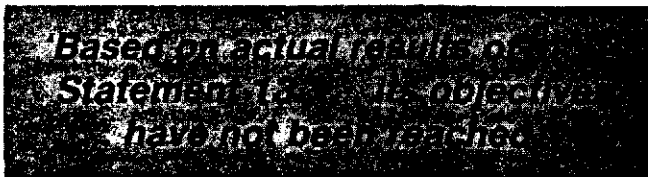
tainable and reasonable. Similarly, estimates of economic lives of 12 to 15 years are not uncommon for equipment covered by an eight-year lease. Thus, for all practical purposes, a lessee is able to overcome the numerical test of paragraph 7c and in clear conscience justify it to himself and his independent auditor. There are, however, extremes that have been taken in this regard, particularly by some major retailers. These assertions and the questions raised by the SEC are discussed in this article.

Nevertheless, the 90 percent recovery test remains the focal point of lease capitalization from the lessee's viewpoint. Accordingly, the implementation problems discussed in this article focus on what the issues are, why there are varying interpretations, to what extremes people are willing to go and what they are willing to give up in negotiating leases that do not meet this test.

One of the best approaches to analyze implementation problems that have beset the practitioner is to study carefully specific issues that the FASB has faced or is facing through issuance of official interpretations and amendments to Statement 13. As of May 1, 1979, FASB had amended Statement 13 four times, had issued six interpretations and had in the exposure stage three additional amendments. In addition, the Board has authorized its staff to develop interpretations on two other lease problems.

### Part-of-the-Building Problem

Certain perceived measurement problems exist in performing lease classification tests for leases involving only part of a building (e.g., floors of a multi-story office building and retail space in a shopping mall). As a result, FASB devised special rules to assist a user of Statement 13 in obtaining objectively determinable costs or fair mar-



ket values of leased space. It provided without any specificity that, with respect to the lessee:

If the fair value of the leased property is not objectively determinable, the lessee shall classify the lease according to the criterion of paragraph 7(c) only, using the estimated economic life of the building in which the leased premises are located.

In practice lessees uniformly asserted that it was never practical to estimate the fair value of a part of a building and thus the 90 percent recovery test was not applicable. Accordingly, only the useful life test was to be applied, and, as discussed previously, this was quickly overcome by applying subjective judgment to estimated useful lives.

Subsequent to the issuance of Statement 13, FASB was asked to clarify when fair value can be objectively determined for a lease involving only part of a building if there were no sales of similar property. The FASB responded by issuing its Interpretation No. 24 in September 1978. It provides that other evidence (e.g., independent appraisal or estimated replacement cost information) may provide a basis for an objective determination of fair value. The Board also acknowledged that (a) it was not imposing a requirement to obtain an appraisal or other similar valuation as a general matter and, (b) a meaningful estimate of fair value "of an office or a floor of a multi-story building may not be possible whereas similar information may be readily obtainable if the leased property is a major part of that facility." This interpretation has had little or no impact on lessee capitalization decisions since Statement 13 continues to be applied literally and information as to fair value remains elusive. Consequently, for the vast majority of leases involving only part of a building or structure, no capitalization is occurring.

### Residual Value Guarantees

In performing the 90 percent recovery test of Statement 13 a lessee is required to include, in the determination of minimum lease payments, guarantees of the residual value of leased property at expiration of the lease. Lessee guarantees of the residual value, while not uncommon, occur most frequently in leases involving personal property such as automobiles. Since the question of residual value guarantees was not a criterion of lease capitalization prior to Statement 13, it was commonplace to find the residual value guarantee at the end of an automobile lease term equating to the balance of undepreciated cost. Consequently, in performing the lease capitalization tests of Statement 13, many lessees initially found themselves in the unhappy position of having to capitalize most of their automobile leases. Almost immediately after this consequence became known to the car lessors, they set out to amend and rectify lease agreements to overcome the capitalization requirements. This was accomplished primarily through a specific limitation on the amount of the residual value deficiency that a lessee would be required to make up and, in some cases, by limiting the guarantee to situations beyond normal wear and tear.

In addition, the Board assisted lessees in this effort through the issuance of Interpretation No. 19 "Lessee Guarantee of the Residual Value of Leased Property." It dealt with lease provisions that require the lessee to make up a residual value deficiency only in cases where the shortfall in residual value is attributable to damage, extraordinary wear and tear, etc., and whether this type of provision constitutes a lessee guarantee of residual value as that term is used in defining minimum lease payments under Statement 13. The interpretation stated that (1) a residual value guarantee is limited to the specific maximum deficiency the lessee can be required to make up,

and (2) a lessee that is required to make up a residual value deficiency attributable to extraordinary wear and tear does not constitute a lessee guarantee of residual value for purposes of defining minimum lease payments.

The practical effect of this interpretation, as it relates to the specified maximum deficiency, can best be demonstrated with an example. Assume a lessee enters into a one-year lease for a current model year Volvo for a monthly rental of \$300. The fair market value of the Volvo at the inception of the lease is \$10,000. The lessee agrees, at the conclusion of the one-year lease, to make up any residual value deficiency on the car between \$3,000 and \$8,000. Thus the lessor takes the risk that a one-year-old Volvo would not be worth at least \$3,000. In computing minimum lease payments, the lessee would compare the \$10,000 to the present value of \$3,600 (1 year's monthly payments) and the \$5,000 residual value guarantee (\$8,000 minus \$3,000). The mechanics of the present value computation lead to a conclusion that the minimum lease payments are less than 90 percent of the fair market value of the car at the inception of the lease. While the mechanical test of Statement 13 for capitaliza-

tion in base rent and a minor increase in percentage rent or simply a decrease in the base sales amount, minimum lease payments could be reduced to enable the present value calculation to equal 89 percent of the fair value of the leased property with a miniscule increase in risk to the lessor.

In other circumstances a rental cost is based on the prime interest rate. The following hypothetical example demonstrates the problem. A lease agreement provides that yearly rent will be a function of the prime interest rate times a given principal amount, with a limitation on the absolute amount of rent per year. The limitation would equate to a prime rate of 4 percent. This yearly amount over the lease term would qualify the lease as a capital lease. Nevertheless, the practical interpretation of Statement 13 would be to classify all payments as contingent and consequently the lease would be treated as an operating lease.

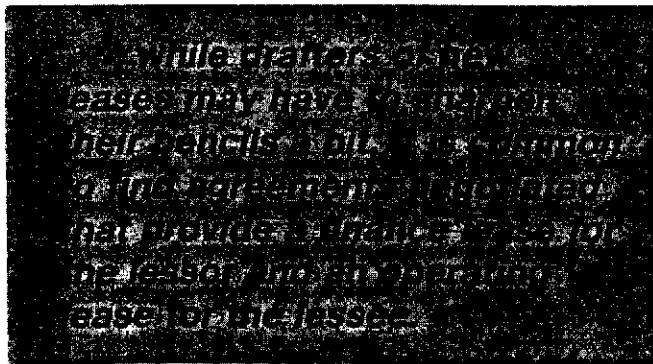
Situations such as the above were brought to the Board's attention and in December 1978, it issued an exposure draft of an amendment to Statement 13 providing that:

Lease payments that depend on an existing index or rate, such as the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals.

This proposed amendment would appear to correct many of the perceived abuses in using the contingent rental clause based on indexes to avoid capitalization.

### Implicit Interest Rate in the Lease

Statement 13 provides that when a lessee is computing the present value of the minimum lease payments for the purpose of measuring whether a capital lease exists, it should use its incremental borrowing rate unless "it is practicable for him to learn the implicit interest rate computed by the lessor and the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate." If both these conditions exist, the lessee is required to use the implicit rate. By and large, the lessor's implicit interest rate in the lease is lower than the lessee's incremental borrowing rate. This is due to several factors including the lessor's estimate of the residual value. In addition, in determining an appropriate rate of return the lessor considers the additional tax benefits that flow to the lessor (e.g., cash flow benefits of accelerated depreciation for tax purposes); these benefits are not considered in the lease evaluation criteria of Statement 13. As most practitioners realize today, a lessee request from the lessor for the implicit interest rate will "reluctantly" be declined. In most situations, the lessee will not press the lessor because the direction of the answer is known in



tion has not been met, it is clear that the lessor has given up very little and yet has been able to achieve an operating lease for the lessee. Thus this interpretation applied literally allows lessees, through a modification of terms that are not economically substantive, to alter substantially the accounting treatment by converting an otherwise capital lease to an operating lease.

### Contingent Rent

Statement 13 provides that contingent rentals, from the lessee's viewpoint, are to be charged to expense as incurred, and not considered part of minimum lease payments for the purpose of performing the 90 percent recovery test. Since many leases contain a base rent and an override based on sales, the override rent is excluded from minimum lease payments in determining lease classification. For example, retail space is often leased at a base rate per month plus a fixed or variable percentage of sales over a predetermined amount. Drafters of lease agreements were quick to realize that by a slight reduc-

advance. As a result, many lessees represent to their CPAs that although they have requested information from the lessor, the lessor has refused to respond. Consequently, when performing the 90 percent recovery test, the incremental borrowing rate is used. As is readily apparent, in a long-term lease, when a present value computation is performed using an interest rate of approximately 10 percent (a rate representative of most companies' incremental borrowing rate today), rentals due after ten years have little or no present value.

This problem was brought to the Board's attention and it has proposed to amend Statement 13 to require the lessee, where practicable, to estimate the interest rate implicit in the lease. In so doing, the lessee is forced into an evaluation of the residual value. This unfortunately raises the issue of how to handle inflation, particularly for leases involving real estate. Should the residual value be viewed as a percentage of original cost based on a depreciable life of 30 or 40 years? Should it take into ac-

count trends of the past eight years of significant inflation? Should it take an historical approach that shows real estate values have increased at a rate, in many instances, that exceed normal inflation? The Board has not answered these questions in its proposed amendment.

**'As of May 1, 1979, FASB had amended Statement 13 four times, had issued six interpretations and had in the exposure stage three additional amendments.'**

count trends of the past eight years of significant inflation? Should it take an historical approach that shows real estate values have increased at a rate, in many instances, that exceed normal inflation? The Board has not answered these questions in its proposed amendment.

Through the comment letters the Board has received on its exposure draft of the amendment of Statement 13 entitled "Lessee's Use of the Interest Rate Implicit in the Lease" it became aware of the problem of estimating residual values. As a result, the Board has directed its staff to address the question of whether expected future increases in value should be considered in estimating residual values. They have also reached the conclusion to defer a decision on the amendment covering the lessee's use of the interest rate implicit in the lease until that question is solved.

In analyzing how the impact of inflation should be considered in determining residual values many would argue that this judgment should be consistent with the other provisions of Statement 13. For example, the Board had emphasized in Statement 13 that upward revisions of residual value are not acceptable. While this appears to relate primarily to the notion that once property is "sold" (capital lease), additional profit recognition by the lessor should not be permitted prior to end of the lease term, it also seems to preclude giving recognition to inflation. It

## The Retailers' Arguments

Perhaps in no other industry are the potential effects of lease capitalization as significant to the balance sheet as they are to large retail chains. The majority of these retailers lease substantially all their facilities under long-term leases, particularly in shopping malls and strip centers.

Readers of large retailer's financial statements were given a warning of the magnitude of the impact of lease capitalization by the disclosures required under Accounting Series Release No. 147. Most readers assumed that the "noncapitalized finance leases" disclosed in accordance with ASR No. 147 would become capital leases under Statement 13. How wrong they were! In fact, less than one half, and in some cases only a small percentage of the "noncapitalized finance leases" have been treated as capital leases under Statement 13.

For example, one large retailer reported over 160 leases with a present value of approximately \$50,000,000 meeting the SEC's definition of a "noncapitalized finance" lease. Reporting under Statement 13, that retailer reported only 50 leases with a present value of \$25,000,000 as capital leases. The major reasons for certain "noncapitalized finance leases" not meeting the capital lease test of Statement 13 were (a) option periods were considered in the lease term for purposes of the ASR disclosures but are excluded in Statement 13's tests; (b) the inability to estimate fair market value where the leased premise was part of large shopping mall; and, (c) the exclusion of leases of a property located in government facilities.

The retailing industry has carefully analyzed the criteria for lease classification under Statement 13 and has sought to take consistent and aggressive positions in interpreting the rules. Recently, the Office of the Chief Accountant of the SEC commented that it would be carefully reviewing the assertions and conclusions reached by the industry since it also was taken back by the lack of capitalization of leased stores and facilities under Statement 13 compared to the disclosures of "noncapitalized finance leases" under ASR No. 147.

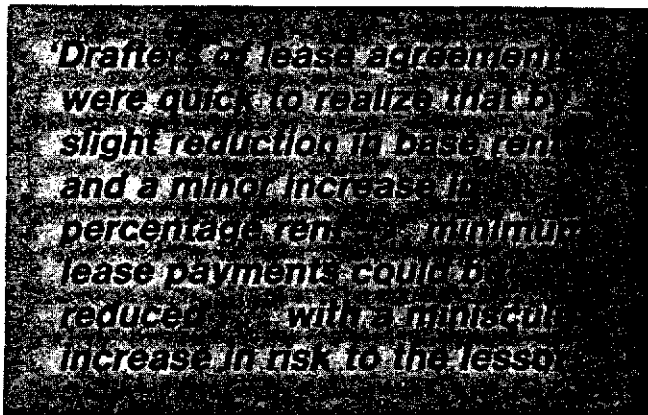
The following conclusions reached by several large retailers in implementing Statement 13 have led to many long-term leases being classified as operating leases.

*Economic life.* Statement 13 defines economic life as:

The estimated remaining period during which the

property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.

The conclusion reached by certain larger retailers was that the life of the property should be measured in terms of a retail enterprise or otherwise. Since alternative uses (warehouses, etc.) exist, they conclude it is reasonable to assume, for purposes of Statement 13, economic lives of 50 to 75 years. Accordingly, the interpretation leads one to conclude that most real property leases should not require capitalization in accordance with paragraph 7(c) of Statement 13. Literally applied, retailers with a 50-year lease could argue a life of 75 years and fail the capitalization test of paragraph 7c. Without arguing the merits of a 75-year life or the apparent inconsistency with the treatment adopted by nonretailers for economic lives of real property, one wonders whether this interpretation is consistent with the words "for the purpose for which it was intended at the inception of the



lease." Namely, is it appropriate to consider the additional useful life as a warehouse that occurs beyond its retail life in determining the economic life under Statement 13?

*Part of a facility.* FASB Interpretation No. 24 attempts to rectify a problem of Statement 13, as covered previously, dealing with leases involving only part of building (space in a shopping mall) by indicating that other evidence may provide an objective determination of fair value. One of the factors to be considered is whether the lessee occupies a major part of the facility. The retailers have concluded that a major part would be equivalent to more than 50 percent of the available space which would be an extreme rarity in a shopping mall. Some believe this was not the intent of the FASB and that a more appropriate interpretation would be that an anchor tenant would be assumed to have information to estimate fair market value. This argument appears to have merit, since anchor tenants are an integral part of the mall and the developer's plans, and it would seem reasonable that the

anchor tenant would often have this information available, though it may only occupy 10 to 20 percent of the mall space.

### Leases Involving Government Facilities

Just prior to finalizing the issuance of Statement 13, FASB added a section under the rules covering leases involving only part of a building. It read as follows:

Because of special provisions normally present in leases involving terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for purposes of classifying the lease is essentially indeterminate. Likewise, the concept of fair value is not applicable to such leases. Since such leases also do not provide for a transfer of ownership or a bargain purchase option, they shall be classified as operating leases. Leases of other facilities owned by a governmental unit or authority wherein the rights of the parties are essentially the same as in a lease of airport facilities described above shall also be classified as operating leases. Examples of such leases may be those involving facilities at ports and bus terminals.

This special exemption had a tremendous impact on the airline industry by allowing them to classify their airport terminal space as operating leases. Many took this exemption also to apply to free standing airline hangars, including maintenance hangars, since the property was on government land and subject to the same considerations as airport terminal space. The SEC raised questions on whether the exemption applied to free standing structures since the exemption provided by Statement 13 was in a subsection covering "Leases Involving Part of a Building." This demonstrated that the SEC was also interpreting Statement 13 literally, although in this case it appeared a bit absurd.

In response to problems such as the one cited in the previous paragraph, the FASB issued an official interpretation—No. 23 "Leases of Certain Property Owned by a Governmental Unit or Authority." The interpretation specifies certain conditions that must be met if the leases in question are to be considered operating leases. One of those is that the lessor has the explicit right to terminate the lease at any time. Since such a right often does not exist, at least certain leases in this area may now require capitalization.

The Board, in response to many comments received that these leases should be subject to the same rules as other leases, gave serious consideration to eliminating the exemption entirely. However, it concluded that further consideration of an amendment should not delay the issuance of the interpretation.

### Where Does This Leave Statement No. 13?

It now appears likely that Statement 13 will rank fourth in number of interpretations and amendments of an

authoritative document, ranking behind only APB Opinion No. 15 "Earnings Per Share," APB Opinion No. 11 "Accounting for Income Taxes" and the all time leader APB Opinion No. 16 "Accounting for Business Combinations." In terms of frustration it may rank higher. These distinctions are not without certain redeeming qualities—countless hours of billable professional time are spent in analyzing lease transactions in light of Statement 13, but one wonders whether this is really productive.

*It now appears likely that Statement 13 will rank fourth in number of interpretations and amendments. In terms of frustration it may rank higher.*

Clearly, from a practitioner's viewpoint, Statement 13 has created practice problems and difficulties by forcing one to rummage through rules, amendments and interpretations when analyzing a lease. Conclusions on lease accounting seem to reach the lowest common denominator in practice, so that most practitioners have concluded that the objectives of Statement 13 and substance over form give way to a literal interpretation of the rules of Statement 13. No white knights are appearing to invoke the Board's objectives, since the Board itself, through its amendments and interpretations has opted, for the most part, to apply the arbitrary rules and percentages literally. To answer the question of why Statement 13 has failed to achieve its objective one must first question the objective itself. From the author's viewpoint, it is questionable whether the objective could ever have been expected to be achieved, since the basis of Statement 13 represented a compromise between capitalizing all leases and capitalizing only those where title passes. Thus, Statement 13 is aimed at a position in between, and the break points are arbitrary. While arbitrary rules may work when the objectives are at the extremes of available options, they rarely work if the position sought is on middle ground.

What then is the solution? Would it not be more workable to require capitalization of all leases that extend for some defined period (such as one year), not on the premise that the lease transfers substantially all the risks

and rewards of ownership of the property, but that the lessee has acquired an asset, a property right, and correspondingly has incurred an obligation. Using this criterion the necessity for most of the rules of Statement 13 would be eliminated, and the lessee's balance sheet would give a better picture of its assets and liabilities.

What are the possibilities of such a scenario? It is difficult to predict but certain events seem to indicate that a rethinking of Statement 13 is probable. In March 1979, the Board met to consider the underlying concepts in accounting for leases. The subject matter was placed on the Board's agenda in view of the number of amendments and interpretations of Statement 13 and the inordinate amount of time the Board has spent on Statement 13 problems since its issuance. It is generally acknowledged that with the present complement on the Board, and the hindsight of the Statement's difficulties, if Statement 13 were submitted to the Board in its present form, a majority vote to issue would not be sustained.

At its March 6, 1979 meeting, a majority of the Board expressed "the tentative view that, if Statement 13 were to be reconsidered, they would support a property right approach in which all leases are included as 'rights to use property' and as 'lease obligations' in the lessee's balance sheet."

The other recent development comes out of the Board's exposure draft on accounting concepts. Many believe that the Board deviated from the definition of an economic obligation given in that document when it defined a capital lease. Eventually this inconsistency must be removed. If one uses the definition of a liability in the proposed statement on accounting concepts, it is not difficult to reach the conclusion that all leases represent obligations to transfer enterprise resources and should therefore be reflected on the balance sheet.

Statement 13 has not achieved its goal in terms of the degree of lease capitalization that its drafters believed would be accomplished or in eliminating most of the inconsistencies between accounting for leases by lessors and lessees. This practitioner believes the cause of failure is with the objective the Board used—an objective, as has been demonstrated, not capable of practical implementation. The Board should recognize its obligation to rethink the issue and its objective, taking into account its new definitions of assets and liabilities, and recognize that while compromise in the setting of accounting principles is necessary in many circumstances, a compromise that doesn't work should be discarded. Ω