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REPORTING OF LEASES

Some Observations on Opinion No. 5 of the Accounting Principles Board

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In September 1964 the Accounting Principles Board, the senior body of the American Institute of CPAs dealing with generally accepted accounting principles, issued its Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee." The Opinion superseded Chapter 14, "Disclosure of Long-Term Leases in Financial Statements of Lessees," of Accounting Research Bulletin No. 43. (Chapter 14 was originally issued in 1949 as ARB 38 by the AICPA's Committee on Accounting Procedure, the predecessor of the Accounting Principles Board.) It is the purpose of this article to comment on certain of the Opinion's provisions and their apparent effectiveness.

APB Opinion No. 5 was issued following publication by the Institute in May 1962 of Accounting Research Study No. 4, *Reporting of Leases in Financial Statements*, by John H. Myers, Ph.D., CPA. The Institute commissioned this study for at least two reasons. First, the use of long-term leases as a financing device to acquire access to real and personal property—a practice frequently referred to as "off-balance-sheet financing"—had increased substantially during the 1950s. Secondly, differences of opinion had arisen within the business community, including the accounting profession, as to how lease commitments relating to real and personal property should be reflected in financial statements.

The differences of opinion had to do primarily with (1) the extent to which leased property, or the right to use it, and related obligations should be reflected as assets and liabilities, and (2) the extent to which noncapitalized lease commitments should be disclosed in financial statements. Accounting for material gains and losses resulting from sales and lease-backs of real and personal property was also involved, but to a lesser degree.

Applicability of Opinion No. 5

APB Opinion No. 5 states: "This Opinion is concerned with accounting for noncancellable leases (or leases cancellable only upon the incurrence of some remote contingency) [of real and personal property except agreements concerning natural resources such as oil, gas, timber and mineral rights] which are material, either individually or as a group for similar types of property, or in the aggregate. The presumption is that if the rights and obligations under such leases are either material in relation to the lessee's net assets or reasonably expected to affect materially the results of operations of future periods, the leases are covered by the provisions of this Opinion."

It is clear from this language that the only ground for exemption of noncancellable leases from the Opinion's provisions (except as regards retroactive capitalization of assets leased under noncancellable agreements in effect at the date of the Opinion's issuance) is immateriality. Thus, the criterion of three years, mentioned in Chapter 14 of ARB 43 as a

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possible basis for distinguishing between long- and short-term leases, while perhaps still appropriate for that purpose, has no relevance for noncancellable lease agreements covered by Opinion No. 5. However, a review of 1965 annual reports indicates that this criterion is still being extensively applied to the Opinion's disclosure provisions. In other words, commitments under noncancellable leases expiring within three years of the balance sheet date often are not disclosed.

When a lease agreement meets the criteria of both noncancellability and materiality, the next aspect of the Opinion to be considered is whether the leased asset and related obligation should be reflected in the lessee's balance sheet or whether disclosure of commitments under the lease agreement is sufficient. The standards for capitalization differ as to lease agreements between nonrelated parties and lease agreements between related parties. Each of these subjects, therefore, is discussed separately below.

Capitalization—Nonrelated parties

APB Opinion No. 5 provides that leased property covered by a noncancellable agreement between nonrelated parties should be capitalized, and the related obligation included in financial statements, if the terms of the agreement result in creation of a "material equity" in the property. It states:

> The presence... of either of the two following conditions will usually establish that a lease should be considered to be in substance a purchase:
>
> a. The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or
>
> b. The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.

In these cases, the fact that the rental payments usually run well ahead of any reasonable measure of the expiration of the service value of the property, coupled with the options which permit either a bargain purchase by the lessee or the renewal of the lease during the anticipated useful life at bargain rentals, constitutes convincing evidence that an equity in the property is being built up as rental payments are made and that the transaction is essentially equivalent to a purchase.

Thus, when the terms of a lease are such that rental payments are designed to amortize the cost of the depreciable property over its estimated useful life (economic life) and to provide for interest in the outstanding loan, and when the renewal rental or purchase option price, if any, is fair, it will usually be apparent that the leased property should not be accounted for as a purchase. This is because a "material equity" in the leased property is not being created by the lease agreement.

The first step in determining whether or not a "material equity" exists is to ascertain whether the renewal rental or acquisition price is fair. Fair rental value upon renewal of a lease is the rental that the lessee would otherwise have to pay for comparable property during the renewal period under comparable terms (e.g. responsibility for operating expenses). Similarly, fair acquisition value at the time of purchase is the amount that the lessee would have to pay to acquire comparable property at the time purchase of the leased property is permitted.

What must be decided is whether the renewal or acquisition cost specified in the agreement will be so low in relation to a fair price to be paid for the rental or purchase of the leased property that the lessee will have, in effect, an equity in the leased property. Because of the impossibility of forecasting future events, such fair rental or acquisition values are not subject to mathematical determination; only judgmental decisions can be made.

In reaching a decision, however, it may at times be useful to make mathematical calculations. For example, it may be desirable to calculate what cost less accumulated depreciation of the leased property would be at the time renewal or purchase is permitted. Such a calculation will usually be indicative of fair value at a future date (ignoring, appropriately, any changes in price levels), since the function of depreciation is to measure the expiration of the service value of fixed assets over their useful lives. The depreciation method used in making this calculation does not have to be the same depreciation method used by the lessee for other property of the same type.

In many instances the cost of the leased property, if purchased outright, is known. When it is not known, the present value of the future rental payments, excluding payments for operating expenses other than depreciation, can be used instead. This value can be computed through the use of an interest table and an implied rate. An appropriate rate would or-

dinarily be the interest rate that the company would have to pay if it were to borrow sufficient funds to purchase the leased property outright, the funds to be repaid over the same period as the lease term. For example, assuming the implied rate was 6 1/2 percent compounded annually, the present value of a series of five rental payments of $600,000 each would be $2,493,408, determined as follows:

Present worth of 1 per period*	$4.1556794381
Payment	600,000
Present value of the payments to be made	$2,493,408

*Source: *Financial Compound Interest and Annuity Tables-Fourth Edition.*

Once it has been determined that an equity in the leased property will exist (by comparing renewal rental or acquisition cost with the applicable fair values), the next thing to be determined is whether the equity is material. In judging the materiality of an equity under a lease, the equity can be compared with the aggregate cost of the related property under the lease. (Interest would, of course, be excluded from this determination.) If the equity were very low in relation to the cost—say 1 or 2 percent—the equity would not be material and purchase accounting would not be indicated. On the other hand, if the equity were relatively high in relation to the cost—say 30 or 40 percent—purchase accounting would be indicated. Between these ranges, judgments would be more difficult.

If it is not clear that a "material equity" in the leased property is not being created, APB Opinion No. 5 states that the existence of one or more of the following conditions will tend to indicate that the lease arrangement is in substance a purchase and should be accounted for as such:

a. The property was acquired by the lessor to meet the special needs of the lessee and will probably be usable only for that purpose and only by the lessee.
b. The term of the lease corresponds substantially to the estimated useful life of the property, and the lessee is obligated to pay costs such as taxes, insurance, and maintenance, which are usually considered incidental to ownership.
c. The lessee has guaranteed the obligation of the lessor with respect to the property leased.
d. The lessee has treated the lease as a purchase for tax purposes.

When purchase accounting is indicated, the leased asset and related obligation should initially be included in the lessee's balance sheet at the discounted amount (present value) of future lease rental payments, exclusive of amounts to cover operating expenses other than depreciation. However, if purchase accounting is indicated and the lessee is reluctant to perform it, the necessity of capitalization will depend upon the aggregate materiality of the total asset, liability, and expense effects when viewed in the light of appropriate balance sheet and income statement criteria.

In the balance sheet, the materiality criteria would ordinarily be the asset and debt structure of the lessee, the debt/equity ratio of the lessee, and similar considerations. Assume, for example, two situations wherein purchase accounting is being considered for leased property having a cost (present value of rentals) of $400,000 and the balance sheets of two different companies show the following (without including the lease in question):

	Company	
	X	Y
Property, plant, and equipment less accumulated depreciation	$250,000	$ 90,000,000
Total assets	800,000	150,000,000
Long-term debt	180,000	75,000,000
Stockholders' equity	300,000	60,000,000

It is clear that Company X should capitalize the lease agreement while Company Y is not required to capitalize the lease agreement for a fair presentation of its financial position.

In the income statement, the materiality judgment would ordinarily be based on the effects of the difference in charges to expense under the lease treatment versus those made under the capitalization treatment—i.e., rent versus depreciation and interest. The cumulative effect on stockholders' equity should also be considered. Frequently, especially in well-established companies, the effects on such items are immaterial, whereas the effects on balance sheet ratios are significant.

If unusual circumstances exist, the criteria and methods of determining materiality just mentioned may have to be modified to fit such circumstances.

It may be, however, that when purchase

accounting is indicated but not performed, exemption from capitalization will be temporary. This is because the Opinion's provisions apply not only to an individual lease but to all leases for similar types of property and to leases in the aggregate. Thus, when a subsequent lease resulting in the creation of a "material equity" is entered into, the need for capitalization will depend upon the effects on the financial statements of all leases which result in the creation of "material equities," and not just the effects of the new lease.

When capitalization is required of a lease not previously capitalized, the asset and liability should be recorded at the then present value of the future rental payments plus, in the case of a purchase option, the option price. In other words, the value assigned to the property should not be what its cost less accumulated depreciation would have been if the leased property had been capitalized initially. Comparative financial statements would not be adjusted retroactively to include the previously noncapitalized lease, because there has been no change in the application of accounting principles but only a change in circumstances (i.e., the degree of materiality).

An examination of the 1966 edition of *Accounting Trends and Techniques,* a publication of the American Institute of Certified Public Accountants, which is based upon the reporting practices of 600 publicly-held companies in the United States, as disclosed in their 1965 annual reports, reveals relatively few instances in which lease agreements between non-related parties have resulted in the inclusion of the leased assets and related obligations in balance sheets.

Capitalization—Related parties

APB Opinion No. 5 provides that under certain circumstances property covered by a noncancellable lease agreement between related parties should be capitalized and the related obligation should be included in the lessee's balance sheet. The circumstances cited in the Opinion are that ". . . a primary purpose of ownership of the property by the lessor is to lease it to the lessee and (1) the lease payments are pledged to secure the debts of the lessor or (2) the lessee is able, directly or indirectly, to control or influence significantly the actions of the lessor with respect to the lease." The creation of a "material equity" has no bearing on the question.

APB Opinion No. 5 states that these circumstances are frequently present where (1) the lessor is a subsidiary of the lessee; (2) the lessee and lessor are subsidiaries of the same parent; (3) the lessee and the lessor have common officers, directors, or shareholders to a significant degree; (4) the lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations; or (5) the lessee or its parent has the right, through options or otherwise, to acquire control of the lessor.

Indirect creation of a related lessor may occur, for example, when the stock of the lessor is owned by a few employees, including officers, of the lessee or their families. However, where the stock of the lessor is in the hands of an outsider (e.g., a financing institution or a pension trust with independent trustees) and the lessee does not have an option to acquire such stock, the lessor and lessee would not ordinarily be considered to be related. The use as lessor of a corporation owned by the pension trust established by the lessee would raise further questions, but the lack of direct or indirect control would appear to exclude such a lessor from the "related" category.

When capitalization is indicated, both the leased asset and the related obligation should be initially included in the lessee's balance sheet in the same manner as an asset and obligation arising from a lease agreement between non-related parties. Again, the only ground for not capitalizing would be immateriality.

Prior to the issuance of APB Opinion No. 5, some companies had formed subsidiaries and/or "dummies" to engage primarily in leasing transactions for the benefit of the parent company and/or its operating subsidiaries. The "dummies" were corporations whose operations were held by individuals nominally independent of the lessee. Frequently, in the preparation of financial statements, the operations of these subsidiaries and/or "dummies" were not consolidated with those of the parent and its other operating subsidiaries. Thus, their debt obligations and related assets were not reflected in the consolidated statements even though the lessee's credit was behind the debt.

To what extent the Opinion's provisions have influenced the way in which companies are now acquiring access to real and personal property through related entities cannot readily be determined from an examination of the public record. Whether or not subsidiaries are used for this purpose should now, however, become an academic question insofar as the preparation of consolidated statements for fiscal periods beginning after December 31, 1966 is concerned. This is because the recently released APB Opinion No. 10, "Omnibus Opinion—1966," contains the following statement: "The Board is of the opinion that, in the preparation of consolidated financial statements. . . , the accounts of all subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities

to their parents or other affiliates should be consolidated."

This conclusion assumes, of course, that "subsidiaries" will be realistically defined in terms of actual control and not just in terms of voting-stock ownership—i.e., that ownership of 51 percent of the voting stock will not be the only criterion applied in determining whether or not a company is a subsidiary. Insofar as "dummies" are concerned, proper adherence to the provisions of APB Opinion No. 5 as they relate to indirect control and influence, and a realistic interpretation of such indirect control and influence, would appear to make their creation useless as a means of accomplishing "off-balance-sheet financing."

Disclosure

The disclosure provisions of the Opinion are as follows:

The Board believes that financial statements should disclose sufficient information regarding material, noncancellable leases which are not recorded as assets and liabilities... to enable the reader to assess the effect of lease commitments upon the financial position and results of operations, both present and prospective, of the lessee. Consequently, the financial statements or accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.

In many cases, additional disclosure will be required. The Board believes that rentals for the current year on leases covered by this Opinion should be disclosed if they differ significantly from the minimum rentals under the leases. Type or types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements (such as restrictions on dividends, debt, or further leasing or unusual options) are examples of other types of information which should also usually be disclosed.

The specific details to be disclosed and the method of disclosure will vary from one situation to another depending upon the circumstances. In many cases, a simple statement will suffice. In more complicated situations, more detailed disclosure will be appropriate. For example, it may be useful to provide a schedule of rentals by years or by three- or five-year periods if annual rentals will fluctuate significantly; or it may be desirable to provide a brief description of the basis for calculating the rental if the amount of rent is dependent upon some factor other than the lapse of time; or it may be necessary to indicate the effect of lease renewals in order to avoid misleading implications.

Thus, the Opinion's disclosure requirements are quite flexible. They cannot be applied by rote. What is appropriate for Company A may be completely inappropriate for Company B. The proper implementation of these provisions requires accountants to exercise a high degree of professional judgment so that the disclosures made are adequate and not misleading. This judgment is limited in only two respects: (1) The amounts of minimum annual rentals must be disclosed and (2) the entire period over which the outlays will be made must be disclosed. In other words, the minimum amounts must always be disclosed, and disclosure of these minimums cannot be limited to only those expected to eventuate during the first five or ten years of a twenty-year lease agreement. This is evident from the statement in the Opinion (emphasis supplied) that: "Consequently, the financial statements or the accompanying notes should disclose the *minimum annual rentals* under such leases and the *period* over which the outlays will be made."

As stated earlier, these provisions apply only to a material noncancellable lease agreement

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EXTRACTS FROM "ABOUT TAXES: 'QUOTABLE' COMMENTS."

Published by Commerce Clearing House, Inc.

"People who squawk about their income taxes may be divided into two classes. They are: men and women."

Anonymous

"Protect the birds. The dove brings peace and the stork brings tax exemptions."

Anonymous

"On the whole, we have been taking our lumps stoicly, knowing full well that this is the lot of the tax collector. Indeed, the Bible offers cases of tax collectors being stoned to death; so in this light, we are not doing too badly."

Sheldon Cohen

the terms of which do not require inclusion of the leased asset and related obligation in a balance sheet. Examples illustrating the provisions are presented in Exhibit 1. As the examples show, only disclosure is required of the fact that the lessee is responsible for maintenance, taxes, and insurance, and of the nature of items such as sales which cause rentals to fluctuate. In other words, the effects of such factors on future rental commitments need not be projected. Thus, the Opinion's provisions recognize the impracticality of forecasting such effects.

As the examples also show, disclosure of the effects of renewal options is required when their exercise could materially affect the data given. Under the Opinion's provisions, disclosure only of the existence of the renewal options is not sufficient. A review of 1965 annual reports, however, indicates that this is the practice generally being followed.

In the examples in Exhibit 1, disclosure is made of the lease commitments in terms of "now" dollars and not in terms of the present value of the rental payments—i.e., excluding an interest factor. This appears to be required by the fact that the Opinion's disclosure provisions do not use the term "present value," whereas the capitalization provisions do. Since in both cases the required payments may span a considerable period of time, the reasons for what appear to be different approaches to the amounts to be disclosed or capitalized when both types of payments include interest factors are unclear. One reason may be that it has not been customary to disclose the total amount of interest which will be paid in connection with debt, but only the interest rate, while it has been customary to disclose the total amount of lease commitments, including any interest inherent therein.

APB Opinion No. 5 does not use the term "aggregate rentals" nor in any way suggest that total rental commitments should be disclosed in one figure. This omission is interesting because the appropriateness of this form of disclosure has been subject to considerable discussion. Some accountants believe that a user of financial statements may be seriously misled by it, because usually an aggregate figure cannot convey an accurate picture on a "going-concern" basis of the status of lease commitments due to the existence of renewal options. Also, some accountants fear that some users may be so surprised by the amount of the single aggregate commitment figure that they will fail to realize or tend to forget that the revenues to pay the commitments may be produced from *leased* assets as well as assets appearing in the balance sheet.

SAMPLE NOTES

Exhibit 1

(NONCAPITALIZED LEASE AGREEMENTS)

SITUATION	NOTE LANGUAGE
Rentals payable in equal amounts over the lease period; no renewal option; lessee not responsible for maintenance, taxes, or insurance.	Annual rentals of $100,000 are payable until 1977 under a noncancellable lease for warehouse facilities.
Same as above, except renewal options exist.	Annual rentals of $100,000 are payable until 1977 under a noncancellable lease for warehouse facilities. This lease may be renewed for two successive five-year periods at the same annual rental.
Rentals payable over different lease periods; lessee responsible for maintenance, taxes, and insurance; minor renewal options exist.	Annual rentals for manufacturing facilities and equipment under noncancellable leases, exclusive of payments for maintenance, taxes, and insurance for which the Company is also responsible, are: $500,000 in 1967-1977; $300,000 in 1978-2007.
Same as above, except additional rentals are due based on sales volume, and disclosure of renewal options is necessary to avoid misleading implications. In addition, the lessee is prohibited from entering into additional lease agreements without the prior consent of its present lessors.	Rental expense under the Company's noncancellable lease agreements covering its retail store locations was $12,000,000. This includes $3,000,000 over the scheduled minimum of $9,000,000 due to the fact that certain of the agreements provide for additional rentals based on sales volume. Future minimum annual rentals under these agreements, exclusive of payments for maintenance, taxes, and insurance, for which the Company is responsible, are: 1967 $9,000,000; 1968 8,000,000; 1969 7,000,000; 1970-1974 6,000,000; 1975-1979 5,000,000; 1980-1984 4,000,000; 1985-1986 3,000,000. All lease agreements contain renewal options. If all such options are exercised, annual commitments under leases in effect at December 31, 1966 will approximate $9,000,000 through 1986 and will decline thereafter at the rate shown in the above tabulation. The Company must obtain the consent of its present lessors before entering into additional lease agreements.

Accounting Trends and Techniques, the only readily available source of such information, reports lease commitment disclosures by lessees in 1965 annual reports (either in the text or in the notes to financial statements) as shown in Exhibit 2. Comparative figures are included for 1963 annual reports to indicate the extent to which these disclosures have changed. With minor exceptions, *Trends* surveys the annual reports of the same companies each year.

However, 1963 figures for obligations assumed or guarantees made were not compiled. This is because an examination of the above-mentioned 1965 annual reports revealed that *Trends* did not include thereunder disclosure of the existence of agreements whereby the lessee assumes responsibility for maintenance, taxes, and insurance. These are items to which the same words in Chapter 14 of ARB 43 were interpreted as applying and to which this writer believes the Opinion is intended to apply.

Since some of the increased disclosures in these annual reports resulted from lease agreements entered into subsequent to 1963, it is difficult to estimate the effect that APB Opinion No. 5 has had on disclosure by the surveyed companies of rental commitments under noncancellable lease agreements. In general, however, so far as companies included in the *Trends* tabulation are concerned, its effect does not appear to have been marked, except possibly with regard to increased disclosure of the type or types of property leased and the increased use of schedules to disclose lease commitments. Whether the effect should have been greater is a question which cannot be answered without access to unpublished information.

It is interesting to note from the tabulation, however, that two types of disclosures not specifically mentioned in APB Opinion No. 5 were made in 1965 annual reports: (1) disclosures of aggregate rentals and (2) disclosures of the number of leases in effect. It is also interesting to observe that of the 81 companies which used the term "minimum annual rentals" to describe their commitments, only 28 indicated that their rentals were based upon factors other than the lapse of time.

Exhibit 2

LEASE COMMITMENT DISCLOSURES BY LESSEES

(AS REPORTED IN 1966 EDITION, ACCOUNTING TRENDS AND TECHNIQUES)

ITEMS DISCLOSED	TIMES DISCLOSED	
	1965	1963
Annual rental amount	141	173
Minimum annual rental amount	81	65*
Aggregate rental amount	18	12
Basis for calculating rent other than time	28	20*
Lease expiration date	56	66
Number of leases	47	41
Renewal or purchase option	46	29
Term of leases	74	63
Schedule of rentals by period of years	31	14*
Type or types of property	81	44*
Obligations assumed or guarantees made	13	—**
Restrictions on dividends, debt, or further leasing	3	2*

*These figures are based upon a separate examination of the 1963 annual reports of companies disclosing such items or using the schedule technique in their 1965 annual reports. These disclosures and use of the schedule technique were for the first time suggested in APB Opinion No. 5. This research was necessary because of the absence of 1963 figures for such items in the 1966 edition of Accounting Trends and Techniques. In an attempt to insure that the 1963 figures would be comparable to the 1965 figures, both the 1963 and 1965 reports of the affected companies (except for five reports which were not readily available) were examined.

**Not compiled.

Sales and leasebacks

APB Opinion No. 5 requires, as did Chapter 14 of ARB 43, that the principal details of any sale-and-leaseback agreement be disclosed in the year in which the transaction originates. It differs from Chapter 14, however, in that it requires, except in rare circumstances, that material gains or losses resulting from such transactions, together with the related tax effect, be amortized over the life of the lease as an adjustment of depreciation. The 1966 edition of *Accounting Trends and Techniques* contains references to several examples of annual reports in which this provision has been applied. The previously discussed capitalization and disclosure provisions of the Opinion also apply to the leaseback aspect of sale-and-leaseback transactions.

Conclusion

Accountants have been concerned for many years with the question of how commitments resulting from lease agreements should be reported in financial statements. The possibility exists that APB Opinion No. 5's capitalization provisions as they relate to lease agreements between nonrelated parties may be amended. Paragraph 18 of APB Opinion No. 7, "Accounting for Leases in Financial Statements of Lessors," states: ". . . There continues to be a question as to whether assets and the related obligations should be reflected in the balance sheet for leases other than those that are in substance installment purchases. The Board will continue to give consideration to this question."

It was upon this portion of APB Opinion No. 5 that attention was focused at the time the Opinion was under discussion. However, until such time as the Opinion is amended, in this or other respects, proper observation of professional standards requires that all of its provisions be observed. It is hoped that this article may provide some assistance in doing so.