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REPORTING OF LEASES IN FINANCIAL STATEMENTS OF LESSEE

INTRODUCTION

1. This Opinion sets forth the Board's views as to proper procedures or methods for implementing generally accepted accounting principles governing accounting for assets and liabilities and income and expense with respect to leases and sale and leasebacks. It supersedes Chapter 14 of *Accounting Research Bulletin No. 43,* "Disclosure of Long-Term Leases in Financial Statements of Lessees." This Opinion makes no distinction between leases of real property and leases of personal property. Because of the highly specialized problems involved, this Opinion does not apply to agreements concerning natural resources such as oil, gas, timber and mineral rights.

2. The two principal recommendations of Chapter 14 of *Accounting Research Bulletin No. 43* were:

(1) . . . where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that:

(a) disclosure should be made in financial statements or in notes thereto of:

(1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable and

(2) any other important obligation assumed or guarantee made in connection therewith;

(b) the above information should be given not only in the year in which the transaction originates but also as long thereafter as the amounts involved are material; and

(c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.

(2) . . . the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is

clearly evident that the transaction involved is in substance a purchase, the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

3. In the period since the issuance of the Bulletin, the practice of obtaining by lease the right to use property has continued on an important scale. Although relatively more information about leases has been disclosed in financial statements of lessees in recent years, no consistent pattern has emerged, and the extent of disclosure of pertinent information has often been inadequate. In addition, there have been relatively few instances of capitalization of leased property and recognition of the related obligation, which suggests that the criteria for determining when a lease is in substance a purchase require clarification.

4. The situation described in the preceding paragraph caused the accounting research division of the American Institute of Certified Public Accountants to undertake a research study on reporting of leases in financial statements.[1] This study recommended, in part:

> . . . To the extent then that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet.
>
> The major question then is what leases, or parts of leases, give rise to property rights. . . . (p. 4)
>
> To the extent, then, that the rental payments represent a means of financing the acquisition of property rights which the lessee has in his possession and under his control, the transaction constitutes the acquisition of an asset with a related obligation to pay for it. To the extent, however, that the rental payments are for services such as maintenance, insurance, property taxes, heat, light, and elevator service, no asset has been acquired, and none should be recorded. . . .
>
> The measurement of the asset value and the related liability involves two steps: (1) the determination of the part of the rentals which constitutes payment for property rights, and (2) the discounting of those rentals at an appropriate rate of interest. . . .
>
> On the balance sheet the property rights acquired under lease should be grouped with the other property accounts, but probably separately classified in order to disclose the existence of the lease arrangement. The liability should be divided into its current and long-term portions and shown in the appropriate classification. . . . (p. 5)

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[1] *Accounting Research Study No. 4,* "Reporting of Leases in Financial Statements," by John H. Myers, published for its accounting research division by the American Institute of Certified Public Accountants in May, 1962. (Accounting research studies are not statements of this Board or of the Institute but are published for the purpose of stimulating discussion on important accounting issues.)

> In effect, the proposed balance-sheet treatment removes the charge for "rent" in the [income statement] accounts as an occupancy cost and instead treats it simply as a payment of an obligation and interest thereon. In its place is put "amortization of property right acquired under lease" (an occupancy cost) and "interest" (a financial expense). In the case of manufacturing concerns there probably would be a related effect on the valuation of work in process and of finished goods. (p. 6)

5. The Accounting Principles Board has considered the recommendations and the supporting argument presented in *Accounting Research Study No. 4*. The Board agrees that the nature of some lease agreements is such that an asset and a related liability should be shown in the balance sheet, and that it is important to distinguish this type of lease from other leases. The Board believes, however, that the distinction depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists. The Board believes that the disclosure requirements regarding leases contained in *Accounting Research Bulletin No. 43,* Chapter 14, should be extended, and the criteria for identification of lease agreements which are in effect installment purchases of property should be clarified. The Board also believes that accounting for gains and losses on sale-and-leaseback transactions should be specifically dealt with in this Opinion.

DISCUSSION

6. The central question is whether assets and liabilities are created by leases which convey the right to use property if no equity is accumulated in the property by the lessee. Chapter 14 of *Accounting Research Bulletin No. 43* and *Accounting Research Study No. 4* agree that leases which are clearly in substance purchases result in assets and liabilities which should be recorded, and that to the extent rental payments are for services, such as property taxes, utilities, maintenance, and so forth, they should be charged to current operations. They disagree with regard to leases which convey merely the right to use property in consideration of specified rental payments over a definite future period.

7. It seems clear that leases covering merely the right to use property in exchange for future rental payments do not create an equity in the property and are thus nothing more than executory contracts requiring continuing performance on the part of both the lessor and the lessee for the full period covered by the leases. The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded.

8. The rights and obligations related to unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements under generally accepted accounting principles as presently understood. Generally accepted accounting principles require the disclosure of the rights and obligations under executory contracts in separate schedules or notes to the financial statements if the omission of this information would tend to make the financial statements misleading. The rights and obligations under leases which convey merely the right to use property, without an equity in the property accruing to the lessee, fall into the category of pertinent information which should be disclosed in schedules or notes rather than by recording assets and liabilities in the financial statements.

9. On the other hand, some lease agreements are essentially equivalent to installment purchases of property. In such cases, the substance of the arrangement, rather than its legal form, should determine the accounting treatment. The property and the related obligation should be included in the balance sheet as an asset and a liability, respectively, at the discounted amount of the future lease rental payments, exclusive of payments to cover taxes and operating expenses other than depreciation. Further, in such cases, it is appropriate to depreciate the capitalized amount for property over its estimated useful life rather than over the initial period of the lease.

10. The property and the related obligation should be included as an asset and a liability in the balance sheet if the terms of the lease result in the creation of a material equity in the property. It is unlikely that such an equity can be created under a lease which either party may cancel unilaterally for reasons other than the occurrence of some remote contingency. The presence, in a noncancelable lease or in a lease cancelable only upon the occurrence of some remote contingency, 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.

11. The determination that lease payments result in the creation of an equity in the property obviously requires a careful evaluation of the facts and probabilities surrounding a given case. Unless it is clear that no material equity in the property will result from the lease, the existence, in connection with a noncancelable lease or a lease cancelable only upon the occurrence of some remote contingency, of one or more circumstances such as those shown below 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 obligations of the lessor with respect to the property leased.
d. The lessee has treated the lease as a purchase for tax purposes.

12. In cases in which the lessee and the lessor are related, leases should often be treated as purchases even though they do not meet the criteria set forth in paragraphs 10 and 11, i.e., even though no direct equity is being built up by the lessee. In these cases, a lease should be recorded as a purchase if 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 following illustrate situations in which these conditions are frequently present:

a. The lessor is an unconsolidated subsidiary of the lessee, or the lessee and the lessor are subsidiaries of the same parent and either is unconsolidated.
b. The lessee and the lessor have common officers, directors, or shareholders to a significant degree.
c. The lessor has been created, directly or indirectly, by the lessee and is substantially dependent on the lessee for its operations.
d. The lessee (or its parent) has the right, through options or otherwise, to acquire control of the lessor.

OPINION

Application of Opinion

13. This Opinion is concerned with accounting for noncancelable leases (or leases cancelable only upon the occurrence of some remote

contingency) 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.

Capitalization

14. Except in cases of leases which come under paragraphs 9, 10, 11, and 12 of this Opinion, the right to use property and a related obligation to pay specific rents over a definite future period are not considered by the Board to be assets and liabilities under present accounting concepts (see paragraphs 6, 7 and 8). Leases of this type involve future rights and obligations, however, and pertinent information should be disclosed as described in paragraphs 16, 17, and 18. In the opinion of the Board, disclosure rather than capitalization is the correct accounting treatment of these leases.

15. Leases which are clearly in substance installment purchases of property (see paragraphs 9, 10, 11, and 12) should be recorded as purchases. The property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement. A note or schedule may be required to disclose significant provisions of the transaction. The method of amortizing the amount of the asset to income should be appropriate to the nature and use of the asset and should be chosen without reference to the period over which the related obligation is discharged.

Disclosure

16. The Board believes that financial statements should disclose sufficient information regarding material, noncancelable leases which are not recorded as assets and liabilities (see paragraphs 13 and 14) 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 the accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.

17. 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.

18. 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.

Sale and Leaseback

19. The principal details of any material sale-and-leaseback arrangement should be disclosed in the year in which the transaction originates.

20. The conclusions in paragraphs 14, 15, 16, 17, and 18 apply to the agreement covering the leaseback as though no concurrent sale were involved.

21. The Board is of the opinion that the sale and the leaseback usually cannot be accounted for as independent transactions. Neither the sale price nor the annual rental can be objectively evaluated independently of the other. Consequently, material gains or losses resulting from the sale of properties which are the subject of sale-and-leaseback transactions, together with the related tax effect, should be amortized over the life of the lease as an adjustment of the rental cost (or, if the leased property is capitalized, as an adjustment of depreciation).

22. Exceptions to the rule in paragraph 21 are expected to be rare. If, however, the fair value of the property at the time of the sale and leaseback is less than the undepreciated cost, the loss should be reflected in income at the time of the sale to the extent that a write-down to recognize fair value could properly have been recorded in the absence of a sale. In other instances in which the use of the leased property changes with the sale and leaseback and in which the sale price falls within the limits which would reasonably be set by independent transactions (for example, companies engaged in both constructing and operating office buildings or other commercial investment properties may sell a property after construction and lease it back for operation), the exceptional circumstances surrounding a particular sale-and-leaseback transaction may clearly justify recognition of all or part of the gain or loss at the time of the sale.

Prior Lease Agreements

23. Unless otherwise stated, Opinions of the Board are not intended to be retroactive. However, the Board encourages the revision of past accounts in individual cases where the effect on current financial state-

ments is material. In any event, the Board believes the conclusions as to disclosure stated in paragraphs 16, 17, and 18 should apply to lease agreements made prior to the issuance of this Opinion.

The Opinion entitled "Reporting of Leases in Financial Statements of Lessee" was adopted by the assenting votes of twenty members of the Board, of whom two, Messrs. Moonitz and Walker, assented with qualification. Mr. Spacek dissented.

Mr. Moonitz assents to the publication of this Opinion because he believes that it will increase the disclosure of pertinent information regarding leases in published financial statements. He does not believe that this Opinion resolves the underlying issue of the nature of assets and of liabilities. He dissents to paragraph 21, which evidences the confusion concerning assets and liabilities. Paragraph 21 recommends that gains or losses from sale-and-leaseback transactions be amortized over the life of the lease. The adoption of this recommendation in practice will result in the introduction into the balance sheet of "deferred credits to income" for gains and "deferred charges to income" for losses. In a sale-and-leaseback transaction, neither of these deferred items qualifies as a liability or as an asset. Their effect is to permit a smoothing of reported net income over a number of years. This result stems from the attempt to treat the transaction as though no sale has been made, insofar as the effect on net income is concerned, while treating the property as sold in the balance sheet. If the property has in fact been sold, it should be so reported in consistent fashion in all the financial statements. If it has not, the balance sheet should not be made to report that it has.

Mr. Walker assents to the conclusions of this Opinion. He believes, however, that adequate disclosure with respect to leases which are considered to be essentially equivalent to installment purchases can be made as well by notes to the financial statements as by inclusion in the figures. Such disclosure is more appropriate because of the legal status and avoids inflating the balance sheet with questionable assets and liabilities.

Mr. Spacek dissents from the principal conclusion that a lease liability should be shown on the balance sheet only when the lease, because of an element of prepaid rent (referred to in this Opinion as "equity") arising from the early lease payments, is interpreted to be an agreement to purchase. In his view, a liability (discounted to present value) should be recorded for all material amounts payable under noncancelable leases, which in fact are "take or pay" contracts, representing a present liability payable in the future. The payment of this obligation has a call on other corporate assets, ahead of corporate equity applicable to investors; and, thus, a liability should be shown on the face of the balance sheet, rather than being relegated to inadequate footnote disclosure. He considers this "equity" to be prepaid rent which should be deferred to the periods to which it applies. It is incorrect to assume that only when rental charges are thus determined to be excessive in early periods does a recordable obligation for future payments result, since this leads to the unsupportable conclusion that the payment of prepaid rent creates a liability and the nonexistence of prepaid rent eliminates the liability. He further believes this Opinion (a) does not explain why its major conclusions disagree with those in *Research Study No. 4,* and (b) establishes criteria for recording lease obligations on an unrealistic and impracticable basis which compounds the ineffective provisions of ARB 43 that have not met the needs of investors and other users of financial statements.

NOTE

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.