This chapter addresses the following topics:

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### 40-1 Applicable Contract Regulations

#### 40-1.1 Applicability of ASC 840 (formerly FASB Statement No. 13)

Guidance for the treatment of lease costs is covered by the Financial Accounting Standards Board’s (FASB’s) Accounting Standards Codification (ASC) 840, Leases. ASC 840 is applicable for any costs incurred during a contractor’s financial statement period ending after September 15, 2009. Previously, lease costs were covered by FASB Statement No. 13, Accounting for Leases. FASB Statement No. 13 was effective for leasing transactions and revisions entered into on or after January 1, 1977. For leases in effect on January 1, 1977, FASB Statement No. 13 was optional until fiscal years beginning on or after December 31, 1980. ASC 840 (formerly FASB Statement No. 13) is incorporated in FAR 31.205-36 (Rental Costs), and FAR 31.205-11 (Depreciation).

#### 40-1.2 Applicability of FAR

FAR 31.205-36 applies to the cost of renting or leasing real and personal property, acquired under operating leases (see 40-4) as defined in ASC 840 (formerly FASB Statement No. 13). If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) apply (see Chapter 19).

#### 40-1.3 Applicability of CAS

The concepts of CAS 404, Capitalization of Tangible Assets, are contained in FAR 31.205-11(h) relative to capital leases. CAS 404 applies to assets acquired by a capital lease as defined by ASC 840 (formerly FASB Statement No. 13). Compliance with ASC 840 (formerly FASB Statement No. 13) and CAS 404 requires that contractors treat capital leases as purchased assets. The capitalized value of such assets should
be distributed over the useful lives of the leased assets as depreciation charges, or over the leased life as amortization charges, as appropriate.

40-2 Capital Leases

If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) and CAS 404 apply (see Chapter 19 and 40-1).

40-2.1 Main Requirements of ASC 840 (formerly FASB Statement No. 13)

Criteria for Classification as a Capital Lease. From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used to classify the lease.

(4) The present value, at the beginning of the lease term, of the minimum lease payments (excluding executory costs such as insurance, taxes, etc.) 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. The 90 percent test should be considered a lower limit rather than a guideline. However, where the lease term begins in the last 25 percent of the estimated economic life, this criterion shall not be used to classify the lease.

Determination and Amortization of Minimum Lease Payments.

(1) Capital leases should be recorded as assets and liabilities at the lower of the present value of the minimum lease payments at the beginning of the lease term or the fair value of the leased property at the inception date. The discount rate used in determining present value is the lower of the lessee’s incremental borrowing rate (the rate the lessee would have incurred to borrow the funds necessary to purchase the asset) or the implicit (lessor’s) rate in the lease, if the implicit rate can be determined. The minimum lease payments are allocated between a reduction of the liability and interest expense to produce a constant periodic interest rate on the remaining balance.

(2) A lessee may use its secured borrowing rate in calculating the present value of minimum lease payments if the rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.
(3) Contingent rentals are the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. See 40-3 regarding lease payments dependent on economic escalation factors.

Calculation of Amortization (Depreciation) for a Capital Asset. The asset shall be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets. See Chapter 19 for a discussion of depreciation costs. The asset shall be amortized over a useful life as follows:

(1) If the leased property reverts to the lessee at the end of the lease or if the lessee is able to purchase the property at a bargain purchase price, then the asset life will be that normally used by the contractor for similar assets.

(2) If the property is leased for a term which is 75 percent or more of the economic life of the asset or the minimum lease payments equal or exceed 90 percent of the fair value of the asset (less applicable credits) then the asset should be amortized over the life of the lease to the value to the lessee, if any, at the end of the lease.

Renewals and Terminations.

(1) If a capital lease is renewed or extended and the renewal is also classified as a capital lease, the carrying value of the asset may require adjustment. When the capitalized value under the revised lease and the present balance of the obligation differ, the asset and liability account is adjusted upward or downward to reflect this difference.

(2) If a capital lease is renewed or extended and the renewal is classified as an operating lease, the existing lease shall continue to be accounted for as a capital lease to the end of the original term, and the renewal or extension period shall be accounted for as an operating lease.

(3) A termination of a capital lease shall be accounted for by removing the asset and obligation with gain or loss recognized for the difference.

(4) The exercise of a lease renewal option contained in a current lease other than those already included in the lease term, as defined by ASC 840 (formerly FASB Statement No. 13), is classified as a new agreement and not a renewal or extension.

40-3 Review of Lease Clauses

40-3.1 Payment of Executory (Occupancy) Cost
Lease clauses regarding payment of executory costs are of particular interest to the auditor. ASC 840 (formerly FASB Statement No. 13) requires executory costs to be excluded when computing minimum lease payments. Executory costs include maintenance, insurance, taxes, and utilities. When the lease clause provides that the lessee pays the executory costs, the lease is referred to as a "net" lease. When the lessor pays these costs, the lease is referred to as a "gross" lease. Since "net" and "gross" are not universally defined, the auditor should review the lease clause to determine exactly what costs are to be paid by the lessee.

**40-3.2 Escalation Lease Clauses**

Auditors should be particularly interested in escalation lease clauses. Recently, clauses containing a provision for increasing lease payments based on the Consumer Price Index (CPI) or some other economic indicator have become common. The increase could be subject to adjustment on an annual basis or when an option is exercised. The escalation may also apply to the purchase price if the lease contains a purchase option.

Computation of Minimum Lease Payments. The decision to include or exclude the escalation for purposes of computing minimum lease payments depends on the specific circumstances, and would include:

1. the factor(s) to which the escalation applies, such as executory costs (which would not be included at all), principal payments, or insurance only;
2. the factor on which the escalation is computed, such as the CPI or prime interest rate,
3. the period to which the escalation applies, such as annually, only for an option period, or the incurrence of some period of time, and
4. the current pronouncements of the Financial Accounting Standards Board.

CPI or Prime Interest Rate. Lease payments that depend on an existing index or rate, such as the CPI or 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 and are excluded from the minimum lease payments (see 740-2)

**40-4 Operating Leases**

**40-4.1 Definition of Operating Lease**

Under the provisions of ASC 840 (formerly FASB Statement No. 13), an operating lease is any lease that is not a capital lease.

**40-4.2 Criteria for Allowability**
The provisions of FAR 31.205-36 apply to all operating leases including those that involve information technology equipment. The main criterion for allowability of operating lease costs is reasonableness. The cost principle states several criteria that should be considered when making a determination of reasonableness. The provisions in FAR 31.201-3 should also be used in evaluating reasonableness of operating lease cost.

40-4.3 Audit Procedures

Comparison with Comparable Property – FAR 31.205-36(b)(1). Included in these criteria is a comparison with comparable property. The auditor must exercise care when determining what is comparable property. To be comparable, the property must be of the same basic age, size, life expectancy, and location. In addition, the lease provisions must also be comparable. Since there are several clauses which can increase time lease costs (see 40-3), the auditor must ascertain what costs truly are included in the comparable property comparison.

Determination of Reasonableness – FAR 31.205-36(b)(1) and 31.201-3. An audit step in testing reasonableness is to review the results of applying ASC 840 (formerly FASB Statement No. 13) capitalization criteria. This is especially critical when reviewing the results of the application of the fourth criteria, minimum lease payments (40-2). Auditors should determine whether the lease term is substantially less than the asset life, and whether the present value of the minimum lease payments is significant as compared to the fair market value of the leased property (for example, greater than 50 percent but less than 90 percent). If this condition exists, there is a strong indication that lease costs are unreasonably high and the audit scope should be expanded.

40-5 Related Party Lease Cost

Leases between related parties are governed by ASC 840 (formerly FASB Statement No. 13), FAR 31.205-11(h)(2), Depreciation, and FAR 31.205-36(b)(3), Rental costs.

40-5.1 Related Party Capital Leases

ASC 840 (formerly FASB Statement No. 13) and FAR Requirements. Capital leases between related parties are discussed in FAR 31.205-11(h)(2) and ASC 840-10-55-27 (formerly FASB Statement No. 13), paragraph 5a). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, costs shall not be allowed in excess of those which would have been incurred if the lease contained terms consistent with those found in a lease between unrelated parties.

Audit Procedures. The auditor should test for reasonableness of rental costs by comparing the present value of lease payments with the fair market value prior to applying the provisions of ASC 840 (formerly FASB Statement No. 13). If the present value substantially exceeds the fair market value, the economic substance of the
transaction should be recognized over the "legal form" (see FAR 31.205-11(h)(2) and ASC 840-10-25-26 (formerly FASB Statement No. 13, paragraph 29). Consequently, costs should be questioned to the extent of unreasonableness due to lack of an "arms length bargaining" (FAR 31.201-3(b)). ASC 840 (formerly FASB Statement No. 13) criteria should then be applied in establishing the appropriate treatment for the balance of the costs.

40-5.2 Related Party Operating Leases

General. Leasing costs between divisions, subsidiaries, or organizations under common control for operating leases are generally allowable to the extent that costs do not exceed the normal costs of ownership (excluding interest or other costs unallowable and including cost of money) (FAR 31.205-36(b)(3)).

Common Control. FAR does not specifically define common control. ASBCA decisions on common control have emphasized the existence or lack of existence of actual common control. FASB ASC 850-10-20 defines control as "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise." The question of whether two entities are under common control is a question of fact. The key question is whether or not one party has the ability to exercise control over the operating and financial policies of the related party. A party may have actual control even if such control is not evidenced by the agreement. Therefore, it is imperative to review the events and transactions that actually occurred in making a determination of whether or not control exists. Two of the most important areas to review are (1) the actual decision making process, and (2) the reasonableness of the lease terms.

(1) A review of the joint venture decision making process is important to determine if control actually exists. For example, if it appears that one company is making practically all the decisions (e.g. the other party is not present at decision making meetings, or if present rarely provides input), this would be an indication that this company is controlling the joint venture. In reviewing supporting documentation, the auditor should remember that percentage of ownership is only one factor to be considered. It is possible that common control will exist even where the controlling individuals own a small percentage of the company's equity. Other factors to consider include, but are not limited to, interlocking management/ownership, identity of interests among family members, shared facilities and equipment, and common use of employees.

(2) The existence of unreasonable lease terms may also provide evidence of control. If the lease terms are unreasonable as compared to those available in the competitive market, it may be because one company has exercised significant influence over the operating and financial policies of the joint venture. Reasonableness may be reviewed by comparing the terms of the lease with:

(a) the contractor's other comparable leases that did not involve a related party,
(b) other comparable leases, and

(c) actual advertised prices for the facilities in question or other similar facilities.

Both the rates (cost per square foot for example) and other terms (such as fixed noncancellable leases versus those with options) must be considered in determining the reasonableness of the lease costs.

While showing that the lease costs are unreasonable will not in itself constitute a determination of common control, it is an important factor in making such a determination. In addition, if the Government is unable to prevail in its common control argument, it nevertheless should prevail in proving that the lease costs were unreasonable at the time of the lease decision under the provisions of FAR 31.205-36(b)(1).

40-6 Sale and Leaseback Transactions

Sale and leaseback transactions are governed by FAR 31.205-16(b), Gains and losses on disposition or impairment of depreciable property or other capital assets; FAR 31.205-11(h)(1), Depreciation, and FAR 31.205-36(b)(2), Rental costs. Effective July 8, 2005, FAC 2005-004 revised the FAR cost principles governing the treatment of costs resulting from sale and leaseback transactions. The rules collectively ensure that the total allowable costs for the use of the subject asset do not exceed the constructive costs of ownership.

Gains and losses on the assets involved in sale and leaseback transactions are recognized on the date the contractor becomes a lessee, in accordance with FAR 31.205-16(b)(1). The gain or loss is the difference between the net amount realized and the net book value (i.e., the undepreciated balance) of the asset on the date of the sale and leaseback transaction. However, gains and losses recognized for Government contract costing purposes are further limited as follows:

(1) Gain transactions – FAR 31.205-16 limits the recognition of any gain associated with the disposition of capital assets to the amount of depreciation costs previously recognized. The Government participates in the cost and credit for the use of the capital asset by the contractor; however, the Government participation in the gain (i.e., credit) does not extend to any appreciation in asset value in excess of its acquisition cost, per FAR 31.205-16(d).

(2) Loss transactions – Sale and leaseback transactions are usually consummated as a means of raising capital; therefore, recognizing losses based on the net amount realized, instead of the fair market value of the asset, may place the Government at risk for reimbursing the costs of raising capital, as well as losses that may be artificially inflated. FAR 31.205-16(b)(2) provides protection to the Government by limiting the allowable amount of a loss to the amount by which the net book value exceeds the fair market value of the asset.
The allowable loss is zero if the fair market value exceeds the net book value of the asset.

Under a sale and leaseback transaction, the annual lease costs are limited to the amounts that would have been allowed had the contractor retained title to the asset. FAR 31.205-36(b)(2) and FAR 31.205-11(i)(1) require that the allowable lease costs be computed based on the adjusted net book value after recognition of the gain or loss, calculated in accordance with FAR 31.205-16(b). The annual lease cost limitation should reflect the constructive cost of ownership and, as such, include the amortization of the adjusted net book value and also other costs of ownership, which may include cost of money, taxes, insurance, etc. The application of the rules ensure that the Government reimburses only its equitable share of an asset's original acquisition cost.

Prior to July 8, 2005, the application of the rules at FAR 31.205-11 and FAR 31.205-36 meant that assets involved in sale and leaseback transactions were not dispositioned (i.e., not subjected to gain/loss recognition) for Government contract costing purposes until the point at which the contractor ceased use of the subject asset. Under prior rules, the gain or loss recognition would generally occur at the end of the lease term. Accordingly, leased assets that resulted from sale and leaseback transactions that took place prior to July 8, 2005 have not been subjected to the recognition of gains or losses, nor do the lease cost limitations reflect such gains or losses. Therefore, to provide equitable treatment of those pre-existing leases under Government contracts subject to the revised rules, auditors should advise the Administrative Contracting Officer that an advance agreement may be beneficial.