Equipping Lease Professionals For Success

Lease Accounting: Separating Myth from Reality
Are the lease accounting rules as bad as they say?
A White Paper by William Bosco

Lease accounting has been a subject of interest and criticism by the regulators since 1995. The Financial Accounting Standards Board ("FASB"), the UK Accounting Standards Board ("UK ASB") and the International Accounting Standards Board ("IASB") as a part of a group called the G4+1 have participated in writing lease accounting papers (the most recent paper was exposed for public comment in 2000) suggesting a "New Approach" to lease accounting. In addition, the Enron debacle in 2001 caused a focus on SPE's and off balance sheet financing, including operating leases. New SEC disclosure rules, the Sarbanes-Oxley Act (SARBOX), FASB Interpretations 45 and 46 were the response. SARBOX required The Securities and Exchange Commission (SEC) to study off balance sheet transactions and their report was issued in the fourth quarter of 2005. Balance sheet restatements involving real estate lease transactions in the financial news in 2004 and 2005 have typically been accompanied by claims that the cause of these restatements was flawed and /or "broken" lease accounting rules. The Financial Accounting Standards Advisory Council (FASAC) to the FASB included lease accounting on its list of the top five priorities at its 2005 meeting, and recommended adding lease accounting to the FASB's 2006 agenda.

What is the truth about lease accounting? This white paper analysis examines the myths that critics assert as supporting evidence that something is wrong with the US lease accounting rules; the analysis also will explode these myths and provide a view of reality.

Before we get into the analysis, let us review some general information on equipment operating leases in the current market environment:

Lease vs. loan

- True equipment leases are executory contracts under commercial law (rooted in common law). Such contracts do not constitute a sale or create a security interest. As the owner of the leased property, the lessor allows the lessee quiet enjoyment if and only if the lessee continues to fulfill its ongoing obligations. Upon an event of default, the lessor has a right to repossess the property and a duty to remarket the leased property in mitigating damages. As the airline industry has recently proved, in bankruptcy, a true lease can be rejected.
- Income tax law treats a true lessor as the owner of the property and affords the lessor the same tax benefits as a user. The criteria used to qualify the lease as a true lease mirrors that of commercial law.

Typical equipment lessees and lessors

- The typical equipment lessee is a small and mid-sized enterprise (SME) who enters into a lease with an original equipment cost of $25,000 - $500,000 and a lease term of 3-5 years.

- The typical equipment lessor is a large financial institution, e.g., banks and commercial finance companies.

Typical lease terms

- The typical lease terms include the right of the lessee to return the leased asset at lease expiry with no further obligations, as well as optional lessee purchase and renewal rights, features which distinguish leases from loans. Due to the maturity of the business in the U.S., market pricing generally does not vary based on the presence or absence of these rights. Credit and equipment value considerations drive the terms and conditions of the lease.

Capital vs. operating lease classification

- The origin of FAS 13's classification system is commercial law. Under commercial law, a lease either creates a security interest (UCC Article 9) or creates an executory contract where the lessor has a meaningful interest in the residual value (UCC Article 2A).
- The requirement that the lessor have a meaningful interest in the residual value to qualify as the owner for commercial and income tax law purposes means that operating lease classification generally occurs "naturally."
- The market-based fluctuation in the value of tax benefits generally cause the present value of the minimum lease payments move closer to or further away from the 90% threshold. During periods of high tax taxes and high interest rates, the present value will naturally fall into the low 80% range. Conversely, during periods of low tax rates and low interest rates, the present value will naturally move close to (or exceed) the 90% threshold.

Myths and Realities

The following is an analysis of the issues commonly cited as problems with lease accounting (the "Myths") and a commentary with clarifications (the "Reality"):

<table>
<tr><th>Myth</th><th>Reality</th></tr>
<tr><td>Lease accounting restatements are evidence that the lease accounting rules are faulty.</td><td>In 2004 there were approximately 200 public companies that restated their financial results due to lease accounting issues. The SEC had found three accounting errors that were prevalent in a number of preparers' statements that they reviewed and they issued a letter pointing out the problems. The issues were:
a. the failure of lessees to account for rent holidays,
b. tenant improvements, and
c. landlord concessions in an operating lease by accruing the average rent and amortizing costs and depreciation over the shorter of the lease term or useful life.
The problem was a compliance issue and occurred only in real estate leases of companies in retail and restaurant businesses, typically large chains. The operating lease accounting rules in FAS 13 are clear and specific and have been followed by the vast majority of lessees since their issuance 30 years ago. In addition, the general accounting principle of accrual accounting should have guided the preparers to the right answers.

The business press reported on the issue numerous times as the restatements grew in number. Most of the articles picked up on the notion that the problem was a rules problem rather than a compliance breakdown. The articles used a broad brush to paint the leasing industry rather than focusing on the fact that it was an asset- (real estate) and industry- (retail/restaurant) specific issue. The restatements were pervasive in the large chain retail/restaurant industry. There was some balanced reporting as the following quotes from experts appeared in an article by Elliot Blair Smith, in USA TODAY entitled <u>Restaurants Have Accounting Trouble with Leases,</u> that best characterize the restatements involving lease issues:

KPMG spokesman Tom Fitzgerald said, "This adjustment involves an isolated number of</td></tr>
</table>

	companies in one industry." Jack Ciesielski of The Analyst's Accounting Observer says, “the misstatements do not appear to have been intentional and the financial effects only minimal. I think it was just a bad policy,” he says. This is now a dated issue that has been resolved, but often the regulators react to headlines and have a long memory.
Leases are engineered to avoid capitalization.	The ELA’s annual Survey of Industry Activity indicates that “structured” operating leases, also know as ***synthetic leases, represented only 1% of new business in 2004.*** The FASB’s new rules and the positive environment created by Sarbanes-Oxley Act and the Public Company Accounting Oversight Board (PCAOB) have had their desired effect of dramatically reducing structured off balance sheet transactions such as synthetic leases. There are still some synthetic leases being done even in this environment and the FASB may consider modifications to FAS 13 to eliminate the rules that are counter to the risks and rewards intentions of FAS 13 and make the classification tests principles-based. Most operating leases occur naturally as a result of tax rules and competition. These leases are also known as “true” leases and are created so that the lessor is considered the owner of the asset for tax purposes and can claim the accelerated depreciation write-offs to defer payment of income taxes. The lease rates are most often lower than loans as a result of the tax benefits. Leases that qualify as true leases under the IRS rules must have a significant residual value at lease expiry (the IRS employees a risks and rewards classification model that is similar to the FAS 13 model). Lessors will assume residual values in booking true leases that will most often be high enough to be classified as operating leases with no financial engineering required. In addition, the higher the residual assumption, the lower, more competitive the lease rent. The market forces create natural operating leases. In many of these operating leases, the lessee intends to return the equipment so that it always has newer equipment with the current technology.
Current lease accounting rules do not recognize	The current accounting rules consider that operating leases are executory contracts where the lessor grants to

material assets and liabilities arising from operating leases.	the lessee the temporary right to use the asset. Current period rent expense from operating leases is reported in the income statement as an operating expense and detailed information is disclosed in the Management Discussion & Analysis (MD&A) and the footnotes on future minimum lease payments due under operating leases. The future minimum payments due are clearly disclosed for what they are, as the MD&A and footnotes are an integral part of the financial statements. The right to use the equipment is not presented as an asset because the lessee clearly has no control of the asset to sell it, modify it or lease it to someone else. Further, at the end of the lease, nothing of value remains. This disclosure has enabled analysts, lenders and investors to understand the future cash requirements from operating leasing activities as well as how the company accesses the use of capital equipment. It is important to expand the current disclosure requirements to provide more useful information. How material are the future minimum lease payments under operating leases? A sample of the 1900 largest companies in the U.S. indicates that the present value of the minimum lease payments reported in their footnotes is approximately 1.5% of their assets and 4.7% of their liabilities. Real estate leases account for over 70% of the dollar volume of operating leases, and retail and restaurant chains are by far the largest volume lessees. Looking at equipment lease statistics only, the vast majority of the transaction volume is comprised of small and mid-sized transactions, as 96% of equipment leases are for equipment that costs less than $5 million. PC, office equipment and vehicles combined represent the majority of the lease transaction volume. The vast majority of lessees return those assets at lease expiry as they value the temporary use of the leased assets above ownership.
The operating lease/finance lease distinction is based on bright line tests that are arbitrary.	Bright line tests serve the important purpose of ensuring consistency of reported results among the thousands of public companies who use large, medium and small accounting firms to certify their financial statements. The real question may be the where to draw the line. The 10% guide to delineate where risk is substantial was not selected at random and without reason, but it is founded in the logic that retaining risk in amounts equal or greater than 10% represents substantial risk.

Lease accounting rules are too complex.	Lease transactions often are complex. The current rules have been developed over 30 years and are well understood by investors and lenders as well as the rating agencies and auditors whose job is to protect investors and lenders. Questions are still raised by preparers and auditors despite the complex, detailed rules. The complexity of lease terms, including options, require detailed definitions of things like the lease term, contingent rents and purchase and renewal options. The reality is that complexity often accompanies an accurate picture of an enterprise's financial condition. Complexity is preferable to incomplete or oversimplified financial reporting. The view that capitalizing all leases is simple and will result in consistency will be at the expense of usefulness, understandability and meaningfulness of the financial reports and will create a costly compliance burden. Capitalizing all leases would only simplify the process of classifying a lease. It would add complexity, burdens and costs to lessee accounting as capitalizing a lease involves: 1) a present value calculation for every piece of property in the lease (could be thousands of PCs and company vehicles); 2) depreciating the asset over the shorter of the lease term or the useful life; 3) splitting the lease payment between imputed interest cost and reduction in implied principal; and 4) accounting for deferred taxes, as the lease is treated as an operating lease for income tax purposes.
Capitalization of operating leases by preparers clearly would give better information.	The information that results from capitalization of leases implies ownership and continued use of an asset beyond the extinguishment of the liability. That is not the case with a true operating lease as the lease must be renewed, the asset purchased or a replacement asset must be leased or purchased to continue use of the asset. Better information does not always result from simply putting more on the balance sheet. It is misleading to capitalize the minimum lease payments of small ticket asset with a short lease term that may be replaced by a new lease again and again. Expanded disclosures would in fact be more useful and informative. The lessee could be required to disclose the

	present value of all operating leases using the appropriate discount rate for each of its leases. The lessee could disclose the weighted average discount rate of all its operating leases. The lessee could disclose its intentions regarding expiring leases, the essential nature of the leased property and projected future rent expense to better predict future cash flow requirements to maintain the needed level of operating assets to achieve its business goals.

What is the right approach to accounting for leases?

If the current lease accounting rules are as seriously flawed as the FASB insists, it could choose to make interim adjustments to eliminate the operating leases structured solely to avoid capitalization. This is the approach that the IASB took in 1999 in revising IAS 17, *Accounting for Leases*. The changes the FASB could make are to eliminate or reduce the bright lines in the current classification tests and to add classification criteria that capitalize leases where the lessee has upside and downside risks in the residual as in a synthetic lease. This is what the IASB did to improve IAS 17.

The other step the FASB could take is to expand disclosure requirements to include the information the analysts calculate and information as to the lessee's intentions at expiry and projections of future rent expense. At its April 5, 2006 educational session on lease accounting, the FASB rejected the idea of making the interim improvements to FAS 13 that would virtually eliminate the areas of shortcoming on which the critics focus before taking up a project to comprehensively re-write lease accounting rules. One would hope that standard-setters stop complaining about FAS 13 if they are unprepared to make the few immediate changes necessary to address the identified problems.

The FASB appears to be set in its views on the right approach to accounting for leases and has said that there is little need to do much more research on lease accounting as the "New Approach" laid out in the 2000 G4+1 paper on the subject would be the correct approach. The "New Approach" views the right to use an asset to be capitalized while FAS 13 views the leased asset as that which should be capitalized. The view that the asset is the right to use is the correct approach.

There could also be a place for not capitalizing certain leases under the New Approach. Specifically, immaterial leases should not be capitalized. Immaterial could be defined as the lease of an asset of less than $50,000 in cost where the original lease term is 48 months or less and the lease is a true lease under the IRS rules. This would have the following benefits:

- It eliminates the work of having to capitalize small ticket assets that have a short life (the average life of a typical 4 year lease is 2.4 years)
- It eliminates the work of accounting for deferred taxes on small ticket short term temporary book vs. tax differences

- It more truly portrays the commercial intent that these transactions are an operating expense (to continuously rent, and return the assets)

This materiality cutoff would cause less than 15% of the current volume of reported minimum lease payments under operating leases to avoid capitalization.

The FASB could require disclosure of the minimum lease payments on these immaterial leases as in FAS 13, but expand the disclosures to include meaningful information as to:

- Essential nature of property under operating leases
- Provide long-term projections of expected operating lease rent expense
- Provide the present value of future minimum lease payments under operating leases using the incremental borrowing rate in effect at lease inception

One hopes that, as the FASB tackles lease accounting, it recognizes that there are many types of leases done for many purposes and that the usefulness of financial statements, simplicity and cost benefit may not be best served by capitalizing all leases without judgment.