40 YEARS OF LEASE ACCOUNTING

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Some 40 years ago, there was more chance of seeing Lord Lucan riding Shergar than seeing a company with a leased asset on its balance sheet! Accounting for leases has been a controversial subject for many years and continues to be today. Generally, the controversy centres on whether it is right for a company that rents an asset to recognise that asset and the corresponding obligation to pay rents for the use of that asset on its balance sheet in a similar way to how it would account for an asset it purchased with borrowings.

The volume of lease finance is big, really big! Typically around one-third of all equipment is financed by leasing. This amounts to over US$1.1bn of new leases being written globally each year. Leasing is an eclectic form of financing; it can finance the use of IT equipment, vehicles, production equipment, aircraft, ships and infrastructure (such as the Thames Tideway Tunnel currently being built under the Thames river in London). Equipment can be leased for a short period of time, such as a matter of hours (e.g. tool hire), through to over 100 years (e.g. real estate).

It is therefore no wonder that it is a significant challenge for the accounting profession to create a single set of rules that cover the wide spectrum of commercial circumstances and different types of use that lease finance serves.

Prior to 1976, companies were expected to recognise "finance leases" on balance sheet if the lease contained a nominal purchase option i.e. the lease was a hire purchase agreement. Refinements to the classification of finance leases were subsequently made and in 1976, FAS 13, Accounting for Leases, was introduced for US companies.

It was not until 1984 that the UK introduced SSAP 21, Accounting for Leases and Hire Purchase contracts. SSAP21 requires leases to be classified as finance leases or operating leases with very different accounting treatments depending on that classification. In brief, operating leases are considered to be, in substance, more akin to the hire of an asset so the lessee is not required to recognise an asset or liability on balance sheet. Operating lease rental payments are expensed through the profit and loss account on a straight-line basis over the term of the lease.

Finance leases are treated as though the lessee has purchased the leased asset with borrowing, so an asset and a liability are reflected on balance sheet. The profit & loss account reflects a finance charge for the finance element of the rentals payable (similar to interest on a loan) and a depreciation expense for the wear and tear of the leased asset.

Operating leases and finance leases

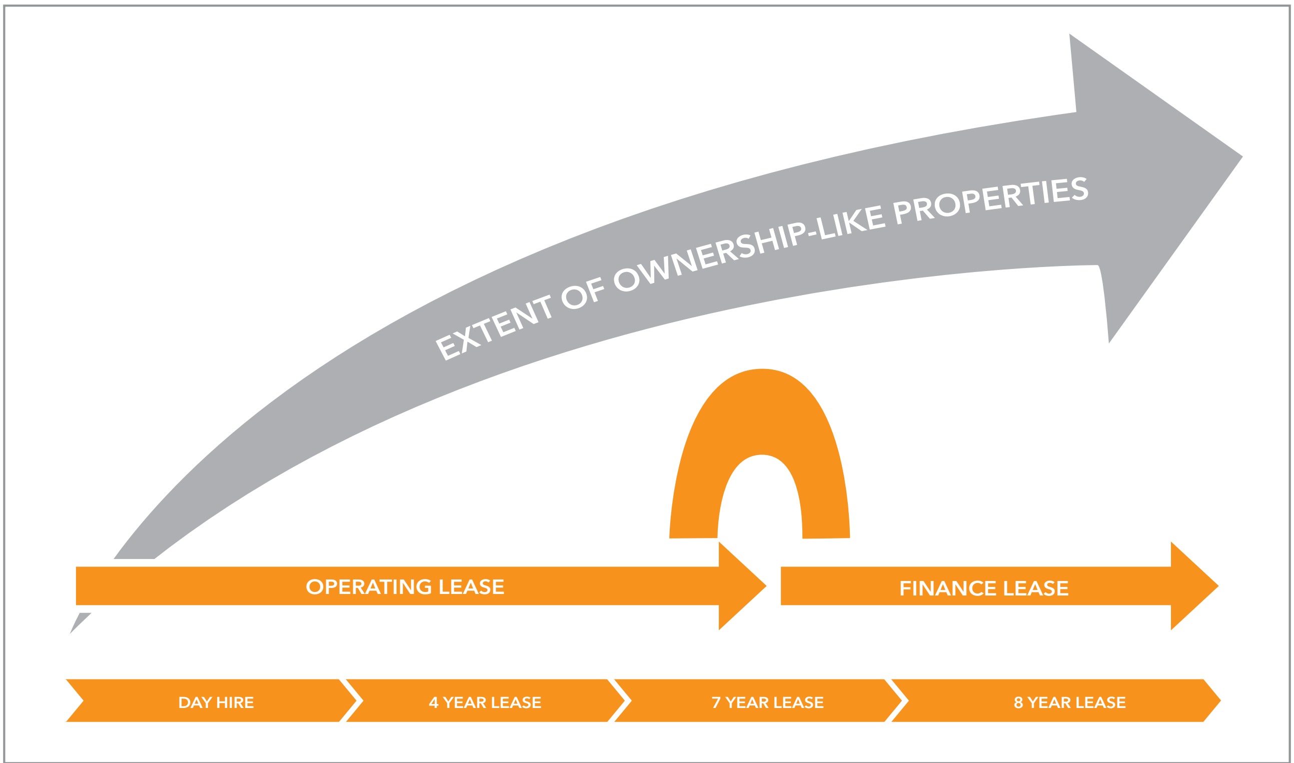
Notwithstanding the introduction of accounting standards for leases in the US and the UK, there remained unease in some quarters that the stark difference in the accounting treatment of operating and finance leases made it difficult for investors to gain an accurate understanding of a company's true indebtedness. Analysts would often use estimates, such as multiplying annual operating lease rentals disclosed in the Notes to a company's accounts by seven or eight times, to approximate the "debt" associated with leased assets.

Furthermore, while it was generally accepted that the accounting treatment for operating leases reasonably reflected the economic arrangement for short operating leases, there was a concern that this was not the case for operating leases with longer terms. Imagine the illustration opposite relates to a truck with a useful economic life of eight years. There should be little debate that if a truck is rented on a relatively short-term basis, such as a day-by-day basis, that the arrangement should not normally require an asset and liability to be recognised on-balance sheet in order to understand the indebtedness of the company.

Similarly, if the truck is leased for substantially all of its useful life, the arrangement is in substance, similar to purchasing the truck with borrowings and should therefore be accounted for in a similar manner to that. However, it can also be seen from the accompanying illustration that if a lease fell just either side of the crescent (shown in the illustration), the leases would be economically similar, but the accounting treatment would be very different.

The stark difference in accounting led to some lessees structuring leases to fall just to the left of the crescent so that they are treated as operating leases. This was particularly the

Operating leases vs finance leases



case in the US where the bright-line tests in FAS13, used to determine whether a lease is a finance lease or not, enabled companies and advisors to fine-tune particular features within a lease so that the lease would meet or fail to meet specified tests to achieve the desired accounting outcome.

For example, generally a lease is classified under US GAAP as a finance lease if the present value of the "minimum lease payments" is equal to or greater than 90% of the fair value of the asset. Provided certain other conditions are met, if the present value of the minimum lease payments are 89.9%, the lease would be classified as an operating lease. Consequently, a relatively small difference in the amount of rent a lessee was obliged to pay could have a significant difference in the profit it reported each year and the amount of indebtedness recognised on its balance sheet.

It was also possible for lessors to structure the way in which leased assets were financed so that only a relatively small portion of the leased asset (and the associated debt) is recognised on the lessor's balance sheet (the so-called leveraged lease).

It took more than a decade following the introduction of lease accounting standards and a run of accounting scandals ranging from Atlantic Computers, Enron and Welcome for the accounting standard setters to turn their eyes back to lease accounting.

G4+1 Special Report

In 1996, the G4+1 published a Special Report, Lease Accounting: A New Approach, written by an Australian Professor, Warren MacGregor. MacGregor criticised existing lease accounting standards for failing to recognise the assets and obligations, created by the contractual rights and obligations, in "most" leases i.e. "operating leases".

In place of existing lease accounting standards, MacGregor proposed a new approach to lease accounting that would recognise an asset and a liability on-balance sheet initially equal in amount to the present value of the amounts that must be paid by the lessee under the lease. MacGregor's proposed treatment of leases would apply to all leases with a minimum term of more than one year.

MacGregor's work led to a further Special Report in 2000 by the G4+1 (Leases: Implementation of a New Approach). The Special Report set out a detailed approach for implementing the principles contained in the MacGregor report into a new lease accounting standard.

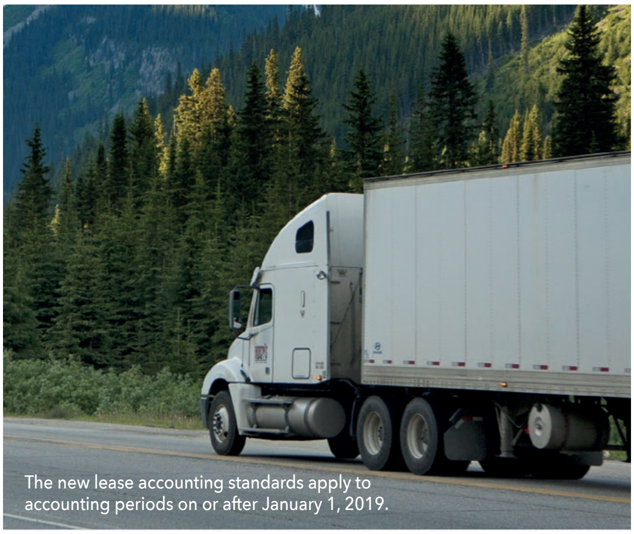
It is often said, 'don't let a good crisis go to waste'. Following the Enron accounting scandal in 2001 the SEC undertook a deep dive into accounting practices that could facilitate corporate fraud. It was considered that the off-balance sheet treatment of operating leases could be used as a mechanism to understate a company's 'true' indebtedness. What followed this conclusion was the longest discussion and implementation of an accounting standard.

IASB and FASB Discussion Papers

In 2009, the IASB and FASB jointly issued a Discussion Paper proposing that all leases (assets and lease obligations) are recognised on balance sheet (very much following the key principles proposed by MacGregor 13 years earlier. An Exposure Draft, published in 2010, invited public comment. The Exposure Draft required all leases to be recognised on balance sheet; being a right-of-use asset and a lease liability. The concept of a 'finance lease' and an 'operating lease' would be no more – from now on, all leases would be accounted for using similar principles.

The Exposure Draft met a great deal of scepticism and resistance from many companies. The number of responses received by the IASB and the FASB was amongst the highest for any proposed accounting standard. This led to an extensive period of discussion, negotiation and practical compromise prior to the publication of a Revised Exposure Draft.

It is worth noting at this stage that the intention was for the IASB and FASB to issue new lease accounting standards that would result in similar accounting treatment whether the reporter was a US GAAP reporter or an IFRS reporter. Unfortunately, the accounting setters could not see eye-to-eye on one or two issues. This was particularly the case


The new lease accounting standards apply to accounting periods on or after January 1, 2019.

for the treatment of leases that used to be classified as operating leases; FASB wanted to retain a straight-line rental expense whereas the IASB considered a front-loaded expense recognition (comprising of an interest expense and depreciation of the right-of-use asset was the better accounting). The standard setters agreed to disagree and in 2016, the IASB and the FASB published their new lease accounting standards.

The new lease accounting standards apply to accounting periods beginning on or after January 1, 2019. A legacy of the two accounting bodies trying to work together is that the IASB's standard (IFRS 16) contains an exemption for "low value" assets, being assets with a value of $5,000 or less) whereas FASB's new standard (ASC-842) contains no such exemption. Perhaps the standard setters new all along the Dollar and the Euro would converge so as not to make a material difference?

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Paul has advised on numerous cross-border financing and leasing transactions including US, German, Swedish, Irish and UK outbound leases. Paul was based in New York during 1995/96 advising leading US companies on expanding into European markets. He was the tax advisor to the UK Government on the privatisation of the UK's passenger rolling stock (the "Roscos").

Paul regularly speaks at seminars and contributes to professional texts and journals, including the World Leasing Yearbook and the principal author of a European Leasing Handbook.