Off-Balance Sheet Accounting by Lessees and Current Proposals to End It

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Abstract

U.S. companies have been engaging in off-balance sheet financing for a few decades. Off-balance sheet items represent real and tangible assets; however, they end up buried in the footnotes and unaccounted for on the balance sheets utilized by potential investors and other financial statements' users. This paper discusses current proposals to require lessees to put all operating leases on their balance sheets, with emphasis on the latest FASB/IASB joint proposal. The project, while likely to enlarge the companies' balance sheets, will ultimately lead to more truthful and transparent financial reporting.

Introduction

It has been clear for almost a decade that financial reporting needs reform. Multiple accounting scandals such as Enron, WorldCom, and recently MF Global, serve as evidence. Companies have found ways to circumvent specific rules set by the Financial Accounting Standards Board; the result being billions of dollars of assets and liabilities not reflected on companies' financials. The absence of significant assets and liabilities from the balance sheet could lead to misunderstandings by financial statements' users, who look to the financial to gain a better understanding of a company's financial position.

With the passage of Sarbanes-Oxley Act of 2002, there have been some general improvements in financial reporting. For example, as stated in the official U.S. Securities and Exchange Commission report performed for the purposes of revealing the Sarbanes-Oxley effects, one of the many improvements is that the issuers of off-balance sheet items must clarify them in detail in the Management's Discussion and Analysis section of their annual corporate report.[1] However, the SEC report also mentions the areas of financial reporting that did not benefit from the Sarbanes-Oxley Act. One such area is accounting for operational leases by lessees.

What Leads to Off-Balance Sheet Accounting by Lessees

According to the FASB's Statement of Financial Accounting Standards No. 13, a lease can be classified as a capital lease only if one of the following criteria are met: the lease transfers ownership of the asset to the lessee by the time the lease ends, the lease has a bargain purchase option, the lease term equals or exceeds 75% of the economic life of the asset, or the present value of the minimum lease payments at the beginning of the lease contract is equal to or more than 90% of the fair value of the asset.[2] If at least one of these benchmarks is met, the lease is no longer considered an operating lease and thus has to be reflected on the balance sheet. Therefore, if the present value of the minimum lease payments equals 85% of the fair value of the asset, then this lease does not have to be capitalized and can be kept off the balance sheets. Therein lies the problem: 85% is dangerously close to the 90% benchmark, so one could argue that conceptually, 85% of the fair value should be enough to classify a lease as capital.

According to the SEC report mentioned above, "the "all-or-nothing" nature of the guidance means that economically similar arrangements may receive different accounting—if they are just to one side or the other of the bright line test."[3] In other words, because of such specific rules, companies might strive to meet the standards and prove that their lease is an operating lease which therefore does not need to be on the balance sheet. However, one could argue that if a company has to pay such a substantial amount for the leased property during an extended period of time.

For example, a case study by Duke et al. demonstrates how much is missing from the balance sheets of FedEx because this company has so many leases it classifies as operational leases.

Using a constructive capitalization model, the authors determined that if FedEx were to capitalize all its unrecorded lease liabilities, the balance sheet would experience an increase of more than $11 billion dollars.[4]

Therefore, if potential investors wanted to invest in FedEx or a similar company with multiple operating lease contracts, they would need to look beyond the picture painted by promising growth prospects and attractive financial ratios. Indeed, in a post-Enron world, potential shareholders have to think twice before investing in a company that has so many liabilities unaccounted for.

As opposed to FASB's bright-line rules, the International Accounting Standards Board (IASB) does not use any specific tests to determine whether a lease should be capitalized or expensed. That is why when companies following IFRS (International Financial Reporting Standards) are deciding whether a certain lease is an operating or a capital lease, they are not trying to blindly follow "overly rules-based standards" but are instead disclosing "the economic objective of each standard, and …the economic motivations for the accounting practices they adopt".[5] In other words, under U.S. GAAP (Generally Accepted Accounting Principles), some companies have historically manipulated the numbers when they wanted to keep a certain lease off balance sheet, whereas under IFRS, more attention is turned to the substance of the lease, and each case is looked at individually.

FASB and IASB Convergence Project

For a number of years now, FASB and IASB ("the Boards") have been working on a project to merge several major accounting principles, among which are the accounting for lessees. In one of its latest joint press releases in June of 2012, the Boards informed the public that any leases of duration of more than a year should be present on the lessees' balance sheets and that there will be no more number-specific clear-cut rules on how to classify a lease, but rather more broad indicators.[6] Indeed, if a company is obligated to pay a fixed sum for longer than a year, it is reasonable to expect that this commitment be reflected on the company's books, because it is a distinct liability. The exact present value of the minimum lease payments should not be the the deciding factor. What should matter is whether the risks and rewards of ownership are transferred from the lessor to the lessee.

Advantages of the New Proposal

With the change of the benchmarks from the specific rule-based to more substance-oriented principles, financial statement users will be better able to judge the financial position of the company. Financial reporting will be more transparent.

In addition, since we are becoming more globally oriented, it will be easier to have the same conventions everywhere. Many companies in the U. S. have business units overseas, so it would be more reasonable to use the same standards for all components of a company, instead of getting entangled in the differences between U. S. GAAP and IFRS. If an investor in Europe wishes to compare a European company to an American one, it is just so much easier for him/her to see the differences if the statements are prepared using the same principles.

Criticisms of the Proposed FASB/IASB Changes to Lessee Accounting

As with many past proposed changes, there are concerns and disagreements. The FASB/IASB proposed changes were not welcomed by many. For example, two Congressmen from California, Brad Sherman, CPA, and John Campbell, CPA, wrote an official letter to the FASB advocating a stop to all proposed changes.[7] They cite the Chang and Adams study as proof that the new lease accounting rules will hurt American businesses, destroy 190,000 jobs, and decrease the U.S. GDP by $27.5 billion. [8] However, one could argue that if the GDP numbers have been historically misstated, a decreasing number would indicate that a mistake was finally corrected. Indeed, a serious error has resulted from companies understating their assets and liabilities, it does not mean that we should avoid correcting the error just because it lowers an economic index. People might be hurt if the GDP actually decreases due to a tangible event, like lowered government spending, for example; however, average people will not be hurt if the only thing that changes is the number describing the GDP.

Similarly, the Chang and Adams study states that the FASB proposal will "increase the apparent liabilities of U.S. publicly traded companies by $1.5 trillion, the equivalent Gross State Product of 20 states."[9] However, if companies finally start to correctly state their liabilities instead of trying to conceal them, the result will, of course, be balance sheets showing their true financial condition.

Alternative Changes to Lessee Accounting

On August 17 of 2010, the Boards released a first draft of the proposed changes to lease accounting, and there was a period when any qualifying parties could submit their comments to this exposure draft and thus have their own say in what the final outcome will be.[10]

At the time of this writing, the Boards have still not come up with the final version. As posted on the official FASB website, the Boards are currently seeking comments from the Private Company Financial Reporting Committee and the Private Company Council.[11]

Meanwhile, various interested parties are coming up with their own proposed changes to lease accounting. For example, in August of 2012 the Equipment Leasing and Finance Association (ELFA) submitted an official letter to both the FASB and IASB indicating that ELFA members no longer support the FASB/IASB lease project and instead would like to see an alternative approach used. ELFA proposes the use of the Revenue Recognition standard as a determinant of when a contract is a sale (capital lease recorded on the balance sheet) or can only qualify as a right of use contract (operating lease not on the balance sheet). In addition, the footnote disclosures should be extended, in which the lessees have to explain in detail the operating leases that are not reported on balance sheets.[12] In other words, ELFA proposes to leave the existing GAAP principles in place but also add a method of calculating a liability and disclosing under operating leases. That way, financial statement users will be provided with more transparent disclosures and the company will not be hurt by having to record additional liabilities. The ELFA proposal is more attuned to keeping the status quo rather than drastically changing existing accounting principles.

Conclusion

Ultimately there has to be changes in how U.S. companies account for their operating leases. It is understandable that a project such as this requires a great deal of coordination time. It is also clear that no matter what the final version of the convergence project, it will not be acceptable to everyone. Companies with substantial operating leases will be the main entities to pay the price for the changes, including compliance costs. However, one might argue that the main reason companies publish their annual financial reports is to provide reliable and relevant information for current shareholders and potential future investors. The main duty of financial managers is to work for the benefit of the shareholders, to whom the managers have to provide clear and true information. Therefore, when the FASB decides on the official changes to its 37-year old SFAS No. 13, those changes ought to have the shareholders' interests at heart.

Notes

[1] Report and Recommendations Pursuant to Section 401© of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filing by Issuers 06.15.05
[2] Statement of Financial Accounting Standards No. 13 11 1976
[3] Report and Recommendations Pursuant to Section 401© of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filing by Issuers 06.15.05
[4] Evaluating Constructive Lease Capitalization and Off-Balance-Sheet Financing: An Instructional Case with FedEx and UPS 04.05.12
[5] The Economic Impact of the Lack of Transparency in Financial Reporting 03.01.08
[6] IASB and FASB Agree on an Accounting Approach 06.13.12
[7] Congressmen Urge FASB to Reconsider Lease Accounting Changes 05.22.12
[8] The Economic Impact of the Current IASB and FASB Exposure Draft on Leases 02 2012
[9] The Economic Impact of the Current IASB and FASB Exposure Draft on Leases 02 2012
[10] Proposed Accounting Standards Update 08.17.10
[11] Summary of Board Decisions 09.25.12
[12] Comments Re: Final Tentative Decisions in the Lease Project 08.30.12

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