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Operating and synthetic leases: Exploiting financial benefits in the post-Enron era ☆

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ABSTRACT

Applying constructive lease capitalization to operating leases of firms in the 2003 S&P 500 index, we demonstrate that currently companies can hide billions of liabilities, enhance retained earnings, income, and ratios by reporting leases as operating. With the rekindled interests of the International Accounting Standards Board and Financial Accounting Standards Board on lease reporting, our study provides valuable and timely information for their decisions.

Results indicate that by reporting operating leases, firms avoided on average $582 million of liabilities (11% of total liabilities) and $450 million of assets (4% of total assets) for our 366 sample firms. Partitioning sample into negative and positive income impact subgroups provides additional insight into firm's motivation for using operating leases. Under lease capitalization the top quartile positive subgroup experienced an 18% increase in income while the top quartile negative subgroup had an 11% decline in income. There was also a significant negative impact on liquidity, leverage and performance ratios.

1. Motivation and background

The collapse of Enron in 2001 and a slew of high-profile accounting scandals (i.e., WorldCom, American on Line, Global Crossing, Tyson, Xerox, etc.) resulted in lowered public confidence in the credibility of financial reporting. In response to the public's outrage at these scandals, Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002. A key provision of the Act was to institute personal liability to corporate executives for any fraudulent misstatements of both financial statements and disclosures. Therefore, there is a perception that firms, in an effort to restore public confidence, and because of the Act, have embraced more conservative accounting policies (Lobo & Zhou, 2006). This perception may be in error with respect to lease accounting. In leasing decisions, firms continue to engage in aggressive policies such as reporting leases as operating leases enabling them to keep significant liabilities and assets off their balance sheets.

Companies have enjoyed the benefits of operating leases for decades since both leased assets and liabilities can effectively be kept off the balance sheet with only footnote disclosures of future lease obligations. A capital lease, whose substance is in essence a purchase, is less popular since it requires both leased assets and liabilities to be reported on the balance sheet. However, the capital lease does produce a benefit, it has a tax savings advantage over operating leases. The tax advantage occurs in the early life of a lease term when a capital lease reports a larger expense, interest expense plus depreciation expense of the leased asset, than an operating lease that only reports the lease payment as an expense.

An additional benefit can be captured through the use of synthetic leases which allow off balance sheet financing while taking advantage of tax benefits. With a synthetic lease arrangement, firms are allowed to report the lease as an operating lease for financial reporting purposes while taking advantage of capital lease status for tax purposes under the provisions of the Internal Revenue Service.[3] Therefore, it is not surprising that synthetic leases have gained prominence among high profile companies, especially companies in the retailing and manufacturing industries, as a vehicle to acquire

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[3] To structure a synthetic lease, a special purpose entity (SPE) needs to be established on behalf of a company (the sponsor) by an independent third party (i.e., a bank with at least 10% equity investment) to acquire the identified asset. The SPE would then lease the asset back to the sponsor under an operating lease provision. For tax filing purposes, the IRS allows the sponsor of the SPE to claim the lease as a capital lease. This is due to the sponsor, in a synthetic lease arrangement, usually guaranteeing most of the loan borrowed by the SPE for the purchase of the lease assets and also the residual value of the lease asset at the termination of the lease. Thus, the sponsor, in a synthetic lease arrangement, assumes the majority of the risks and benefits of the lease asset. This arrangement provides the IRS the basis to treat the sponsor (i.e., the company) as the owner of the lease asset and grant a capital lease tax filing status to the sponsor.

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assets through a special purpose entity (SPE) and then lease back these assets to the companies as synthetic leases (Danvers, Reinstein, & Jones, 2003).

Benston and Hargraves (2002) found that after the negative publicity of Enron's use of SPEs to hide billions of liabilities and inflate earnings, among others, the popularity of synthetic leases declined. In addition, the development and issuance of more stringent accounting regulations for the SPE by the Financial Accounting Standards Board (FASB) in 2002 and 2003 have further restricted the use of the synthetic leases.[4] As a result, not only has there been a reduction in the number of new synthetic leases but we also witness a decline in the total number of preexisting synthetic leases. Even though the use of synthetic leases is presently restricted, they are still available for firms who may use them to avoid the consolidation of the assets and liabilities of their SPEs (FASB, 2002; Danvers et al., 2003; Kaikati, 2004).

Despite a diminishing use of synthetic leases as a result of accounting scandals and more stringent SPE regulations, the ability of firms to hide billions of lease obligations through the use of operating leases is still prevalent. For example, US Airways group Inc. reported only $3.15 ($2.9) billion in long-term debts on its 2003 (2006) balance sheet but had $7.19 ($9.16) billion future *operating* lease obligations on passenger jets disclosed in the footnotes. Walgreen Co. reported only $4.21 ($7.02) billion of total liabilities on its 2003 (2006) balance sheet but disclosed $19.3 ($26.4) billion of future *operating* lease obligations on retail stores in the footnotes.[5] At a market level, the staff of the Securities and Exchange Commission (SEC) estimated that the current accounting standards for leases allow publicly traded companies to keep $1.25 trillion (undiscounted) future (operating) lease commitments off balance sheets (SEC Report on Off-Balance-Sheet Activity to the Congress, 2005).

A major contributing factor to the prevalence of operating lease reporting is the manipulative nature of the current rule-based accounting standard for leases. Based on Statement of Financial Accounting Standards (SFAS) No. 13 (FASB (1976): Accounting for Leases), managers can structure a lease not to meet the specified criteria of capital leases to avoid the reporting of lease assets and liabilities. For example, SFAS 13 allows companies to report leases as operating leases if, among other criteria, the present value of future lease payments is less than 90% of the fair value of the leased asset. Therefore, a company can ensure operating lease status by structuring the present value of lease payments to equal 89.99% or less of the fair value of the lease asset, among other conditions.[6] In contrast, had the lease met the 90% rule, or another of the capital lease criteria, the lease liability and asset would be reported on the balance sheet as well as interest and depreciation expense on the income statement.[7]

The Accounting Standards Board (ASB) of the United Kingdom and the first Position Paper of the G4 + 1 (1996) both acknowledged that the major deficiency of the existing lease accounting standards is the lack of recognition of material lease assets and liabilities arising from operating lease contracts.[8] In the United States, the Financial Accounting Standards Board (FASB) has received many criticisms from its constituents (i.e., Financial Accounting Standards Advisory Council, the User's Advisory Council of FASB, etc.) on the lease accounting standard's failure to provide transparent, consistent and complete information pertaining to lease transactions in addition to the problems of not recognizing the lease assets and liabilities. In a response to these criticisms, an effort to curtail the off-balance sheet lease financing and to promote international convergence of accounting standards, the FASB and the International Accounting Standards Board (IASB) added a joint project on leases to their respective agendas in July 2006. The objective of the joint project is to develop new accounting standards for leases to ensure a complete and transparent recognition of assets and liabilities arising from lease contracts on financial statements. According to FASB's December 2008 project update, both IASB and FASB (referred to as the Boards) agreed to measure lessee's right-to-use assets and its lease obligations based on the present values of future lease payments using the incremental borrowing rate of the lessee at the *inception* of a lease. The IASB decided to apply this measurement to all leases, and therefore, made no distinction between capital leases and operating leases. However, the FASB called for more study on the needs for the differentiation between "in-substance purchases" and "right-to-use an asset" leases in the *subsequent* presentation and measurement.[9]

Despite the acknowledgement of reporting issues in lease accounting by national and international accounting standard setters, only a few studies have empirically documented evidence of the impact of the exploitation of lease accounting by public companies, especially those traded in U.S markets.[10] These prior studies examined the financial impact of operating leases by either using the constructive lease capitalization method suggested and demonstrated in Imhoff et al. (1991) or a heuristic capitalization method. The empirical evidence of these studies supports the perception that reporting leases as operating leases results in off-balance sheet financing, earnings enhancement and an improvement in financial ratios such as return on assets and the debt to equity ratio. However, the sample size of these prior studies, with the exception of Ely (1995)

[4] For example, the FASB issued Interpretation No. 46 (R) (FIN 46 (R)): Consolidation of Variable Interest Entities (VIE) in December 2003 (FASB (2003)) to require the VIE (or SPE) to be consolidated if a higher minimum equity investment (from 3% of total assets to 10%, or more for VIE with risky assets) is not obtained, among other conditions.

[5] An article published on Wall Street Journal (Weil, September 22, 2004) singled out six firms as major users of operating leases for off-balance sheet financing in the post-Enron era. US Airways group Inc. and Walgreen Co. are among these six firms. A subsequent WSJ article (Reilly, July 18, 2006) identified five firms with large off-balance sheet lease liabilities as Walgreen, Sprint Nextel, CVS, FedEx, and Citigroup.

[6] The other three criteria, besides the fair value rule, to report a lease as a capital lease are: the lease provisions containing: 1) a transfer of ownership at the end of lease term; 2) a bargain purchase option; and 3) the lease term is equal or greater than 75% of the leased asset life. As long as the lease contract meets one of these three criteria or the 90% rule, the lease is reported as a capital lease.

[7] In FASB's discussions with the IASB (2008), an objective has been to ensure that there is complete recognition of assets and liabilities of lease contracts on financial statements. Thus, the present use of operating leases to hide significant amounts of liabilities and report substantially different financial statements for leases with similar economic substance may be curtailed in the future.

[8] Examples of the accounting standards for leases include: the Statement of Financial Accounting Standard No. 13: *Accounting for Leases* of the U.S., (issued in 1976), the Statement of Standard Accounting Practice (SSAP) 21 of the U.K. (issued in 1984.), and the International Accounting Standard No. 17 of the International Accounting Standards Board: *Leasing* (issued in 1982) and International Financial Report Standard No. 5 (issued in 1994). These standards all allow two different accounting treatments (operating versus capital) for leases. Note that the G4+1 research papers were the joint work of six accounting standards boards: Australia, Canada, New Zealand, U.K., U.S., and the International Accounting Standards Board.

[9] As for the presentation of leases, the IASB decided to report leased assets based on the nature of the underlying assets while the FASB decided to report them as either "in substance purchases" or only conveying "the right to use". In addition, both Boards agreed that the lease term for leases with options such as renewal, termination and purchase should be determined at inception based on the assessment of those options. The Boards also decided that the lessee should reassess the lease term and its obligations (based on the updates lease term) at each reporting date. As for the contingent rental and guaranteed residual values, both Boards decided that a lessee should estimate its lease payments considering the possible outcomes of these events. A discussion paper presenting both Boards' view on the revision of lease accounting pertaining to lessees is expected in February 2009. An Exposure Draft is expected by April 2010 and a final standard is expected by June 2011 (Kashyap, 2008).

[10] These studies include Imhoff et al. (1991, 1993, 1997), Ely (1995), Beattie, Edwards and Goodacre (1998), Goodacre (2001), Bennett and Bradbury (2003), and Duke and Hsieh (2006), etc.