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Considerations on the subject of lease accounting

Giulia De Martino

Department of Accounting, Faculty of Business Administration, Luiss Guido Carli, Viale Romania 32, 00197, Rome, Italy

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ABSTRACT

The question of the correct method for recording lease transactions has already been the subject of debate both domestically and internationally for some time now (2009). The discussion on a set of rules for recording such operations has recently been fuelled by the inclusion in the FASB and IASB's agendas of a joint project regarding accounting rules for both the lessor and the lessee. To this very moment the preliminary output of this joint project has been the drafting of a *discussion paper* published on 19 March 2009. The present work offers a critical commentary on the main innovations introduced by the boards on the subject of lease accounting and illustrates an alternative accounting model which, starting with the identification of the essential economic elements of any lease contract, would be best suited to representing, in accounting terms, the reasoning and the actual purpose of a lease transaction.

1. Introduction

During the course of 2004 both the IASB and the FASB agreed on the need to make substantial changes to rules currently in place for the reporting of lease operations with reference to the financial statements of both *lessors* and *lessees*.

The idea underpinning the joint project of the two Boards is that of developing a new single accounting model applicable to the various categories of lease and, consequently, the idea of eliminating the existing classification which, depending on the "nature" of the contract, draws a distinction between operating lease and finance lease.

The foundation of the current accounting method used to report lease transactions can be found in Statement 13, published by the FASB in 1976, subsequently taken up and reworked by the IASB for the purposes of issuing IAS 17.

The principle underpinning both standards is that lease transactions, representing a form of loan, must be subject to basically the same accounting treatment as that resulting from the acquisition of ownership by means of a traditional "loan".

A consequence of this approach is the assertion that lease transactions in which a substantial transfer of all the risks and benefits deriving from acquisition of the leased item is taking place have to be classified as "finance leases", and must accordingly require the lessee of the leased item to record it amongst assets, and at the same time to record the corresponding associated financial liability amongst liabilities.

On the other hand, lease transactions that do not have the above features should be classified as "operating leases". For these types of lease, no liability has to be recorded by the lessee in the balance sheet, but it the obligation to enter the periodic rentals owed to the lessor in the income statement, period by period, still exists to comply with the accruals principle.

Ever since they were issued, the content of both Statement 13 and IAS 17 has never enjoyed great consensus amongst scholars or field operators. Both standards have been repeatedly criticised, with a general criticism on the inadequacy of the rules drawn up to correctly distinguish the various components of lease transactions as well as of the actual nature of many of them.

In greater detail, the main objections to the currently adopted method are concerned with:

1. the difficulty in identifying objective criteria to draw a clear distinction between operating lease and finance lease. Critics point in particular to the fact that the classifying principles set forth in both standards can fuel and favour the spread of discretional behaviours tending to subordinate some transactions to meet the company's accounting needs. Often, indeed, non-withdrawable lease transactions represent a form of financing, yet they do not always result in the creation of a liability for accounting purposes. This is the case if they are structured in such a way as to fall under the classification of operating lease, entailing the non-recording of the relative financial debt. In other words, it is argued that the current model accentuates companies' tendency to operate so that in accounting terms lease transactions fall in the category of operating lease, turning them in *off-balance-sheet*, with a consequent positive effect on capital *ratios* (Beattie, Goodacre, & Thomson, 1998; Bowman, 1980; Duke & Hsieh, 2006; El-Gazzar, 1993; Finnerty, Fitzsimmons, & Oliver, 1980; Fulbier, Silva, & Pferdhirt, 2006; Gopalakrishnan & Parkash, 1996; Imhoff, Lipe, & Wright, 1993; Kilpatrick & Wiburn, 2007; Nelson, 1963; Wilkins & Zimmer, 1983a, 1983b);

E-mail address: gdemartino@luiss.it.

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2. the possibility that the same transaction (or similar transactions) may be recorded using different accounting methods depending on whether or not conditions are given that determine the they fall within the parameters identified by standards for the classification of finance leases (Giunta & Bonacchi, 2001);
3. the possibility that both the lessee and the lessor of the same transaction find themselves in different conditions such as to warrant a dissimilar qualification of the same lease transaction.

This criticism on the currently adopted accounting model is highlighted in particular by the two *special reports* published by the G4 + 1 working group in 1996 and 1999 respectively (McGregor, 1996).[1] These reports examined existing shortcomings in accounting standards referring to lease transactions, and proposed an alternative and innovative accounting approach, consisting of reporting operating leases in the balance sheet too, by placing values to the assets and liabilities emerging from them according to their respective *fair values* (Lipe, 2001; Ryan, 2001).

In the European Union the drive to change the ways of reporting lease transactions has come mostly from professional associations, whilst in the US the push for change has additionally come from a regulatory body, the SEC, in particular by virtue of the release of the *Off-Balance-Sheet report* in June 2005.

In the above-mentioned document the SEC stressed the inadequacy of the existing US accounting standard on lease, with special reference to the fact that reporting rules are based on the identification of parameters to define an artificial cleavage amongst different lease types (so-called *bright lines*) (Rieger, 2006).[2]

For these reasons the Authority, in its subsequent document "*Final Rule*: *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*", in an attempt to increase balance sheet transparency and improve the quality of accounting information, obliged US companies to record in their balance sheets, providing appropriate *disclosure*, all those "*off-balance sheet arrangements*" whose effects can be considered as *material* by *management*, with reference to both the current economic and financial positions of the entity and its potential future developments.

The SEC has thus obliged companies not only to specify the nature and economic purposes of *off balance sheet* transactions, but also to identify and place on the deriving assets, obligations and liabilities, including potential ones, deriving from such cases, and to conduct an analysis of the relative effects on the financial position, and on eventual changes to the same position and on liquidity. These rules, as can easily be realised, have had an effect on rules for reporting and representing lease transactions, for which companies are obliged to provide adequate *disclosure* of the relevant terms and conditions of each contract, pinpointing all cases in which, it might be necessary to accelerate payments, reduce duration terms or create further financial obligations.[3]

The set of criticalities raised over time with reference to the current approach on lease standards thus led to the two boards – of the IASB and the FASB – adding to their 2006 agenda a project regarding the "reform" of leases, aimed at reconsidering all aspects of its accounting methods from the point of view of both the *lessor* and the *lessee*.

The results of this still ongoing process will lead to the issue of a new, shared accounting standard, making possible to overcome existing differences between the FASB and IASB accounting systems on leases, and to outline a common standard of higher quality capable of meeting the need to represent the real economic substance of the lease transaction.

The project, according to initial declarations made by the two boards, was meant to include a *fundamental review* of existing methods for reporting lease transactions. For the moment being, however, it appears to address only the simple "adjustment" and fine tuning of rules already in place and not a complete reappraisal of the logical–conceptual framework of existing standards that might shed some light on the intrinsic peculiarities of any lease transaction.

This paper analyses the essential and "universal" economic characteristics which, regardless of the reference to the regulatory and legislative context and of the relative qualification in the various accounting systems, define lease transactions, distinguishing it from the "traditional" direct purchase and from other types of contract.

Then, after having briefly describing the main differences in the reporting rules currently in place according to the SFAS and the IFRS system will be discusses the new model agreed upon and presented in the *preliminary discussion paper* that calls for observations and comments from different *standard setters*, bodies and organisations taking part in the relative *due process*.

Finally, moving on from the examined economic characteristics of the transaction and from the criticalities observed in the proposed joint model, the guidelines of a unique possible alternative accounting model to be applied by both the lessor and the lessee will be illustrated. This model would be best suited to represent, in accounting terms, the essence and the real rationale of any lease transaction, regardless of the many forms and varieties that it may effectively take on in practice.

2. Essential economic characteristics of the lease contract

The notion of leasing goes back an extremely long way, back to the English feudal system. In that system a concept of ownership was developed that was able to include a structure of relations between men and things based not on powers that were absolute, like the Roman *dominium*, but on a multitude of prerogatives and rights of a temporary nature, centering more on the use of property than on the formal title of ownership. The English model has always associated with this concept, which we can define as "extended" ownership, a purely 'patrimonial' component, deemed to merit autonomous protection in the legal sphere (Candian, Gambaro, & Pozzo, 2002; Gambaro, 1997; Grossi, 1963; Megarry Sir Robert & Thompson, 1993; Moccia, 1999).

With its origins in such a legal system, the lease transaction has always been characterised by the importance attached to the enjoyment of the *res*, be it movable or immovable. This fact is translated in the granting of the right from the lessor to the lessee to use a given *asset* for a given period of time upon payment of a previously agreed fee.

This transaction is characterised by the peculiarities that set it apart and by the needs of the parties met through such a contract, in other words the objectives pursued by such a transaction.

As some have noted, indeed, the lease transaction is characterised by the fact that it serves to ensure "*uti frui predominantly in the productive sphere*" (Acierno, 2004; Guerrera, 1987; Imbrenda, 2005;

[1] G4 + 1 was a group formed by representatives of *standard setters* of Australia, Canada, New Zealand, Great Britain, United States and the IASC (*International Accounting Standards Committee*).

[2] See the document Report under the Sarbanes Oxley Act from June 2005: "*The lease accounting standards rely extensively on bright lines, greatly increasing the potential for similar arrangements to be portrayed very differently. Indeed, for a lessee, the accounting can flip between recording no assets and liabilities at lease inception to recording the entire leased asset and entire loan price with only a very small change in economics. As discussed previously, the bright line tests have served to facilitate significant structuring of leases to obtain particular financial reporting goals. The extensive structuring further erodes the effectiveness of the standards.*"

[3] See the document Report under the Sarbanes Oxley Act from June 2005: "*This proposed disclosure requirement also includes provisions in financial guarantees or commitments that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity or the creation of an additional financial obligation*".