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Leases: Off-Balance Sheet Financing and the Strive for Transparency Today

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Abstract

In today's world, leases appear far and wide; they are commonplace throughout the business and accounting frontiers. Accounting for leases, however, is not so clear cut. Since there are various ways to account for leases, many companies pick and choose which they feel best suits their situation, even when this sweeps dirt under the rug along the way. The financial procedures for dealing with leases should entail benefits as well as limitations to ensure each company is fairly representing all of its financial information. Off-balance sheet financing is one of the hot topics in accounting for leases because of the implications it imposes on financial reporting. This thesis will discuss these implications, as well as the continuing search for convergence of FASB and IASB as they strive to make leases as transparent and honest as possible.

Leases: Off-Balance Sheet Financing and the Strive for Transparency Today

Historical Perspective

Lease accounting dates back well into the early decades of the 20th century. The Securities and Exchange Commission (SEC) was formed by congress in 1934 to enforce the Securities Act of 1933 as well as the Securities Exchange Act of 1934. These acts were established in response to the crashing fall of the 1929 stock market and the great depression. The boldness of certain financial indecencies that surfaced following the crash made some of today's scandals look like petty, schoolyard, kind of slap on the wrist misbehavior. It has been suggested that at a time when the New York Stock Exchange traded the shares of approximately 800 companies, the prices of more than 1/8 of these were openly manipulated by syndicated stock pools (Ethiopis, 2005). Before the great depression, regulations existed in the form of Blue Sky Laws on securities regulation, but were not very effective. Disclosure of financial information throughout the roaring twenties was voluntary. Even though many companies typically had audited financial statements along with an attorney review, these failed to be effective because the lawyers, auditors, and brokers worked for companies, and not for potential investors. Investors seemed to trust dividend payments rather than income statements as a trust indicator of a companies' financial condition. Upon the creation of the SEC in 1934, companies were required to publicly disclose all relevant information. The SEC served to restore investor confidence with these new regulations by ending the misleading sales practices and stock manipulations that caused the stock market crash of 1929.

With the establishment of the SEC, the American Institute of Certified Public Accountants (AICPA) and the SEC began to set standards for accounting practices. This

led to the Committee on Accounting Procedure establishing Accounting Research Bulletins (ARB), which were first published in 1939 and included 51 bulletins concerning various accounting procedures. ARB 38 was issued in October of 1949 with the concentration almost solely on disclosure. The bulletin concluded when the transaction involved is in substance a purchase, that leased property should be included among the assets of the lessee while also accounting for the corresponding liabilities (Burton, Palmer, & Kay, 1981). The dissolution of the committee in 1959 discontinued the issuance of ARB's and gave rise to the Accounting Principles Board (APB).

The APB pronounced 31 opinions and 4 statements; several have a significant influence in areas of accounting theory and practice, including accounting for leases. APB 5, *Accounting for Leases in Financial Statements of Lessees* was issued in 1964 with the determination to provide a better definition of when a lease was in substance a purchase (History of lease accounting, 2007). APB opinion 7, *Accounting for Leases in Financial Statements of Lessors,* was issued in 1966 and this covered the lessor's end of the deal. Opinion 7 dealt mainly with accounting distinction between an operating lease and financial leases (Burton, Palmer, & Kay, 1981). This is just a fragment of the various categories and characteristics for each type of lease; further classifications of leases will be discussed in detail later. Also pertaining to leases, APB 27, *Accounting for Lease Transactions by Manufacture or Dealer Lessors,* came about in 1972. This was created to end the prevalent and progressing abuse that manufactures and dealers were harnessing by interpreting opinion 7 their own way in order to accommodate their own methods and situations. Specifically, the APB issued this opinion to determine when a manufacturer lessor should recognize a lease transaction with an independent lessee as if it were a sale

(Burton, Palmer, & Kay, 1981). This was influential because this opinion finally established some solid criteria to determine if the transaction was in-substance a purchase or not. In the following year, APB 31, *Disclosures of Leases Commitments by Lessees,* was introduced and it expanded on the disclosure requirements for lessees; basically requiring enough information for the normal knowledgeable financial statement user could roughly estimate the effects and outcomes would be if the company capitalized leases (History of lease accounting, 2007). Opinion 31was the last opinion to be released by the Accounting Principles Board; shortly after APB 31, the Accounting Principles Board was discontinued and replaced by the Financial Accounting Standards Board (FASB).

Modern Day Standard Setting

Following the dissolution of the Accounting Principles Board, the Financial Accounting Standards Board was created in 1973. The SEC designated FASB as the source for standard setting of public companies in the U.S, and FASB achieved this primary purpose by developing Generally Accepted Accounting Principles (GAAP). However, international accounting is monitored by a different body, the International Accounting Standards Board (IASB). Even though both boards have their own separate standards, they are continually striving to correspond, compromise, converge, or do whatever it takes to present the most valuable and honest information to investors.

Orientation to Lease Accounting

One of the most important issues relating to leases under U.S. GAAP is the principle of substance over form (Spiceland, Sepe, Nelson, Tomassini, 2009). This is one of the principles upon which accounting is founded. It states that financial reports must

reflect the true nature of transactions, their economic substance, and not their legal nature or substance. Under GAAP principles, a transaction that is legally formatted as a lease, but by its true nature is a sale, should be accounted for as a sale (Spiceland, Sepe, Nelson, Tomassini, 2009). However, current accounting regulations may be encouraging, or at least allowing, the opposite.

Financial Accounting Standards Board Lease Classification

Accounting for leases was one of the very first projects FASB undertook. After two years of collaboration, FASB issued its first pronouncement of SFAS 13, *Accounting for Leases, in* November of 1976. Under SFAS 13, operating leases are treated as simply rental agreements. However, their substance may be much closer to a debt financed purchase. Companies can structure their operating leases so that they are just under the rules set by FASB to be accounted for as a capital lease. According to Edward Nusbaum (2007), ". . . too many transactions are structured for the purpose of arriving at a desired accounting treatment" (p. 6). When companies tweak their leasing agreements just to get them classified as operating leases, the spirit of the accounting regulations is defied.

Operating Leases

Many companies choose operating leases because of their legitimate advantages. Under operating leases the lessee generally does not bear the risks of ownership. The lessor often bears the risk of over estimating residual value, since the lessor is the owner of the asset. The lessor is also responsible for taxes and insurance (Lubove, 2002). The burden of depreciation expense and amortization is also borne by the lessor. All these advantages are appropriate when the operating lease is indeed a rental agreement by nature.

Arguably the most attractive advantage of operating leases is that they can be used as a form of off-balance sheet financing. However, this causes much confusion. When a company acquires an asset with debt financing, a liability shows up in its financial statements alerting investors of the claims against future income. When an asset is leased, however, no liability is created even though the company has entered into a lease contract and is legally obligated to make lease payments in the future. It is no surprise then that many experts think operating leases should be classified as a liability. Steve C Lim (2003), from The University of Texas' accounting department says, "Ratings agencies and finance textbooks agree that long-term lease obligations represent debt, regardless of the accounting treatment" (p. 3). Current FASB standards require that operating leases be disclosed in financial statements. Judging from notes alone it can be laborious to accurately estimate operating lease obligations, according to Amy Feldman (2002) writing for *Money*.

In some industries operating leases make up the bulk of financing arrangements. Feldman notes (2002), "Operating leases are popular in industries that use expensive equipment" (p. 46). The airline industry is a perfect example. Feldman (2002) goes on to say that AMR, the parent company of American Airlines, leases 362 planes. Of these, 240 or roughly two -thirds, are under operating leases. If such leases were accounted for as debt, it would drastically alter AMR's financial appearance.

Operating leases are not always abused. Many times they are truly the simple rental agreements that they're packaged as. FASB has also created guidelines for what constitutes an operating lease. If these requirements are not met, a capital lease is used. Capital leases do not keep anything off the balance sheet. This will be discussed later.

Synthetic Leases

Much more dangerous than operating leases are their cousins, synthetic leases. Under a synthetic lease, a company creates a special purpose entity (SPE). The SPE exists solely to provide the parent company with an operating lease. Synthetic leases keep debt off the parent company's books under current accounting rules. The SPE is considered part of the parent company for tax purposes. Seth Lubove (2002), editor for Forbes Magazine, wrote the article “Debt? Who, Me?” and stated, “promising the best of both worlds, synthetic leases allow companies to keep debt off the books but deduct interest and depreciation as if they had bought and mortgaged the place” (p. 56). The parent company gets the tax benefits of ownership but conceals the liability. As with operating leases, only a footnote disclosure is required. If this kind of financial finagling seems reminiscent of Enron, that's because it is. SPE's are nearly synonymous with the shell corporations that set off the Enron catastrophe. Shockingly, synthetic leases are perfectly legal. Lubove goes on to quote Kevin Nunnink, chairman of real estate consultant Integra Realty Resources. Nunnink (2002) candidly reveals the nature of this type of financing and states, “Under current accounting, synthetic leases are legal, but they are a subterfuge, a way to keep debt off the balance sheet" (p. 57).

Ironically these kinds of transactions are exactly what FASB and the Sarbanes-Oxley Act attempt to eliminate. The reforms instituted in the wake of Enron's collapse to deal with this issue, may not be going far enough.

Off balance sheet financing such as operating and synthetic leases not only inflates corporate earnings and misrepresents their financial positions, but it allows them to maintain the ratios needed to satisfy debt covenants. This lessens the influence of such

covenants, because the companies are not actually keeping their debt ratios low; they're misrepresenting the amount of debt they are carrying.

Despite the tireless efforts of FASB, and the actions of legislators, Wall Street will always find loop holes. In the near future FASB may indeed reign in unruly leasing techniques. There will always be a desire, however, to artificially bolster balance sheets and income statements. Ethical professionals, who willfully present transparent financial statements, are the only true way to prevent misconstrued financial statements. Likewise users of financial data will always have their work cut out for them. Investors must be diligent to discover a company's true financial state. FASB will never rid the world of every accounting inconsistency. Trying to do so is not futile, however, as it keeps accounting practices in line enough that the job of the investor is not impossible. Off balance sheet financing via operating and synthetic leases are only one of the issues that the accounting profession will have to reign in.

Capital Leases

The other classification of a lease in the business world today is a capital lease, sometimes referred to as a finance lease (Spiceland, Sepe, Nelson, Tomassini, 2009). One of the fundamental ways companies obtain expensive equipment in the business world today is through capital or finance leases. Capital leases sometimes allow companies to be able to use and eventually own equipment and material that they would not otherwise have the funds to purchase completely up front. FASB has laid out four criteria that a lease must meet in order to be classified as a capital lease. The lease only needs to meet one of these four criteria in order to be classified as a capital lease.

The first criteria that a lease must meet in order to be classified as a capital lease is that "the agreement must specify that ownership of the asset transfers to the lessee" (Spiceland, Sepe, Nelson, Tomassini, 2009, p. 760). When ownership is transferred, the lessee then has full control of that asset. Before the ownership has been transferred, the lessor maintains all the risks of owning that asset. This is a fairly simple requirement to meet and understand.

"The agreement must contain a bargain purchase option" to be considered a capital lease (Spiceland, Sepe, Nelson, Tomassini, 2009, p. 760). This criterion gives the option for the lessee to purchase the asset at a lower price during the lease if they choose to do so. If a lessee was going to make payments on an asset and then still be required to pay full price for that same asset, neither party could record the previous transactions as a capital lease.

The third criteria that FASB set for a lease to be classified as a capital lease is that, "the non-cancelable lease term is equal to 75% or more of the expected economic life of the asset" (Spiceland, Sepe, Nelson, Tomassini, 2009, p. 760). This number of 75% is admittedly somewhat of an arbitrary number. But FASB set this number along with the fourth criteria that is, "the present value of the minimum lease payment is equal to or greater than 90% of the fair value of the asset" (Spiceland, Sepe, Nelson, Tomassini, 2009, p. 760). This last criterion is the one that people have trouble avoiding if they are trying not to write a capital lease and keep the lease off the balance sheet.

Capital leases make the company's balance sheet have more liability as opposed to an operating lease. Because of the lower liability the company has if it makes an operating lease, Teh Hooi Ling (2005) of The Business Time Journal Singapore states

that, “operating leases may indicate a higher efficiency in terms of asset turnover and return on assets” (p. 13). By committing to a non-cancelable capital lease, a company automatically increases their liability. Investors will look at the asset turnover and see that it is less efficient when a company has a capital lease than if it were to have an operating lease. In reality, the company may actually be better off reporting the lease as a capital lease because, “the total expense of a capital lease would be lower and fall below that of an operating lease as the interest charges declined following the repayment of the lease liability” (Ling, p. 13). So if a company reports their lease as an operating lease it may have a lower liability, but it will increase their expenses. Companies can tweak and bend the stipulations of these lease agreements to make them look the best for their company which leads us to the next issue with capital leases.

U.S. GAAP and FASB Main Goals

The U.S. GAAP and FASB principles are fundamentally set to make financial accounting reliable and trust worthy. By reporting leases as operating leases instead of capital leases, companies keep these leases off the books and therefore make their liabilities look smaller than they actually are. Paul Kerin (2007) reported for The Australian that, “about 90 percent of Australian leases are off balance sheet and most companies have some” (p. 2). This is almost the whole business community that is reporting these leases off the balance sheets legally. Even though there is a huge push to document leases to accurately reflect actual business activity, people continue to search and find loop holes on the standards set by FASB. Kerin (2007) goes on to say that, “a huge financial engineering industry provided a "how to" guide for structuring lease deals to keep them off balance sheet” (p. 2).

Capital leasing can be a very valuable business decision if it wants to purchase a piece of equipment but does not have the capital to buy that piece of equipment outright. Andrew Jones (2008) of the Birmingham Post says that, “buying equipment outright needs a huge amount of capital investment that at times prevents the business owner from investing in other projects” (p. 12). A company can use a capital lease or an operating lease to broaden the scope of their business endeavors. Jones (2008) goes on to state that taking a lease may allow a company to have more “working capital to maybe expand into other areas or to take advantage of unexpected opportunities that may arise” (p. 12). While capital leases may be considered to be a sale in reality, it still allows a company freedom to maintain their focus on other business endeavors.

International Accounting Standards Board Lease Classification

“The mission of the International Accounting Standards Board (IASB), which replaced the International Accounting Standards Committee (IASC), is to develop a single set of high quality, understandable, and enforceable global accounting standards and work with national standard setters, such as the Financial Accounting Standards Board (FASB), to achieve worldwide convergence or harmony” (Fletcher, 2002, p. 14). The FASB is constantly trying to decide on whether or not to make the transition to the IASB set of rules, making the IASB universal for all accountants and their practices. The notion of the possible switch has been debated for many years but until recent years has it become heavily pressured and favored by many resulting from the infamous corporate scandals that have taken place. Some believe the scandals such as Enron and WorldCom would not have happened if the IASB rules had been the set standard while some spectators and analysts believe the scandals may have been worse.

FASB vs. IASB

The main concern for governance when trying to decide whether or not to remain with FASB rules or switch to IASB standards comes when investigating the framework of both standards. FASB standards are focused around a set of rules and principles that should be followed when determining how to account for transactions while IASB is focused on the practice of professional judgment, or objective orientation (Spiceland, Sepe, Nelson, Tomassini, 2009).

When accounting for leases, the IASB employs an objective oriented framework in the IAS 17; the purpose of this rule is to use professional judgment when accounting for leases rather than following a given set of rules and principles as the FASB's SFAS No. 13. The goal remains the same: to distinguish the lease as an operating lease or a capital lease. The foundation within the operating lease and the capital lease is still the same. If someone is buying an asset with lease payments and using that as another lease payment defines the lease as an operating lease because there is no recording of assets and liabilities. If an object is being leased and is recorded as an asset and a liability to pay for the asset then it constitutes a capital lease. Believers in the IASB foundation believe that framework the FASB uses provides an excuse for corporate officials to use when a scandal becomes known: "The FASB's criteria were designed to aid the accountant in determining whether the risk and rewards of ownership have been transferred. Many would argue, though, that the result has been the opposite. Rather than use the criteria to enhance judgment, management and its accountants can use the rules as an excuse to avoid using professional judgment altogether and instead focus on the rules alone" (Spiceland, Sepe, Nelson, Tomassini, 2009, p. 18).

Finance Leases

When accounting for leases using the IASB's IAS 17, the judgment on determining whether or not the lease is a capital lease, or a "finance" lease under IAS 17, is still derived from similar classifications used by the FASB. Instead of meeting every qualification to classify the lease, the judgment is made by meeting a number of "indicators" that lead to belief of total transfer of ownership title. By using the IASB financial reporting system, more professional judgment is required when determining how to account for the lease and less specificity. The goal of the IASB is to be the global International Financial Reporting System (IFRS), but the main obstacle that hinders the position is that the Securities and Exchange Commission (SEC) still use the U.S. General Accepted Accounting Principles (GAAP) when measuring jurisdiction in companies (Tinker, 2009).

Present Value of Minimum Lease Payments

Assets that are leased are recorded by the lessee at the assets fair value or the present value of the minimum lease payments, whichever happens to be lower. Many object to the use of fair value rules, which allow assets to be marked down to present market prices, or marked to market. The fair value rules and laws have been blamed and stamped on politicians, arguing that the banks are to blame and their losses are the reason assets should be marked down to the current market prices: "The IASB, which sets the rules for most countries apart from America, has made the tactical decision to avoid the nightmare scenario of banks and politicians writing the rules themselves" (Economist, 2009, p. 88).

In using fair market values and the implicit interest rates, one very important difference between IASB and FASB can be determined. By using the IAS 17, both parties involved in a lease agreement use the implicit rates given to discount the minimum lease payments and the FASB's SFAS No. 13 states that lessors get to use the implicit rate and lessee's will use the incremental borrowing rate unless the implicit rate is known and is the lower rate (Spiceland, Sepe, Nelson, Tomassini, 2009). Here we can examine that the FASB clearly supports a fair value option when accounting for leases and is the one topic that keeps many supporters on the FASB side when arguing on whether or not to switch to and use the IASB approach. A recent survey was performed and found that only 24% of financial executives supported the idea of switching to the IASB framework afraid of breaking away from the fair value regime (Economist, 2009, p. 88).

Off-balance Sheet Financing: In Depth and in Debt

Behind the Scenes Look of Off-Balance-Sheet-Financing

One dirty little secret of financial reporting is off-balance sheet financing. Managers will strive after it like the holy grail, throwing themselves about like they are chasing after the wind. The goals, premises, and outcomes of off balance sheet financing all have severe pros and cons, but they seem to be subjective to each managers own motives.

Pros

Managers want to take on debt while reporting none or only some of it as liabilities on their balance sheets. The decision to keep debt on or off the balance sheet comes down to financial leverage. Operating and capital leases are directly related to

whether a company wishes to obtain greater or lesser financial or operating leverage. With operating leases, debt does not appear, thus reducing financial leverage with an increase in operating leverage. This is flip flopped if a company opts for capital leases. With a capital lease, the debt is recorded, expenses are financial, and financial leverage is hindered (Torre and Hamilton, 2009). Often, management's goal with off balance sheet financing is to provide a better looking balance sheet with lower reported debt to equity ratio, which usually results in driving their stock price higher.

Cons

Think about this common idiom: "One man trash is another man's treasure." Off balance sheet financing has created its own little business proverb very similar because the very same pros in off balance sheet financing are seen as complete disadvantages to someone within the same profession who holds just a little different perspective. Off balance sheet financing lovers want higher stock prices even if it means keeping shareholders in the dark. Their side's rebuttal claims they are within GAAP standards, but a more ethical approach shows that there are other available choices that don't mislead. Often times, management's wild goose chase to hide debt doesn't pan out because spend far more than they can gain by deception while at the same time destroying their credibility (Miller & Bahnson, 2010).

Controversy Laden Leases

When accounting for leases, it seems the advantages and disadvantages seem to contradict each other depending on one's perspective. To one, the simple ability of being able to classify a lease as operating and leave it off the balance sheet is all fine and dandy in the grand scheme of things. To another, this same situation is the accountant's demise

because they feel they are not presenting each and every company's financial information in the right light.

Both Sides of the Coin

In an article entitled, Reprise: Off balance sheet financing is dysfunctional, two sides discuss or rather debate whether the nature of operating leases and off balance sheet financing is beneficial or not (Miller, P., & Bahnson, P., 2010). Joe Smith is a divisional chief financial officer for a large company, a former Andersen auditor, and an erstwhile accounting instructor. In his response to the article he weighs in heavily on the proposed idea that the way he accounts for leases is completely fundamental and ethically sound, and he doesn't see why there would be a need to change the accounting rules or try to amend them to different standards. Joe is somewhat taken aback by some of the comments when he states, "Generally I find your articles thought-provoking and enlightening and generally espouse a different point of view than how we working accountants think about things. But I do get tired of one of your continuing themes that we are somehow dishonest in what we do…" (Miller, P., & Bahnson, P., 2010, p. 1). In a sense, Smith is being honest about their company following the rules, but maybe a cinch more dishonest when overlooking if these rules are producing outcomes that are as truthful.

On the contrary, Paul B.W. Miller and Paul R. Bahnson are both professors at universities and respectfully but adamantly oppose Joe Smith. They believe that operating leases definitely are off balance sheet financing and they explain that if one can't see these flaws in GAAP, then they are not competent. Furthermore, if one does see these flaws and still doesn't provide the best information, then they are not to be trusted. Either

way, Paul and Paul feel they are dysfunctional because off balance sheet financing hurts the markets, their clients, as well as their stockholders (Miller, P., & Bahnson, P., 2010).

Differences Revealed

Smith and company are pretty well content that clear and concise disclosures are good enough to represent the items that are clearly omitted from the balance sheet. Paul and Paul and many accountants alike feel the invisibility of these assets and debts on the balance sheet is enough to make off balance sheet financing unfair. If disclosure is good enough, why not leave losses and expenses off the income statement and just merely put them in the footnotes? Paul supports his ideas by quoting the CFA report which says: "Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur do not achieve the purpose of financial reporting" (Miller, P., & Bahnson, P., 2010, p. 1).Paul and Paul feel they are obliged to look objectively at financial reporting and continually seek ways to make it better. They feel that financial users are not well served and preparers like Smith don't seem to care.

FASB and IASB Converge

Financial reporting is not about what looks best for the company; it is about what "*is*" best for the company. The overall purpose of the accounting profession as a whole follows the AICPA code of conduct which states that CPA's are obligated to duties and responsibilities that include serving the public interest, honoring the public trust, and demonstrating this commitment to professionalism(CPA Journal, 1991). Attached to this proposed professionalism comes professional judgment. Professional judgment vs. personal judgment is an important key for accountants to understand procedures and apply them in the most honest way possible. Certain companies and their employees have

been using too much personal motives towards classification of leases as operating capital, thus hindering the integrity and transparency of their company's information. Because of this continual representational unfaithfulness, FASB and IASB have initiated a joint project to establish a new approach to lease accounting that would ensure a more credible and transparent reflection of leasing transactions.

The Proposal: Capitalization All Around

On August 17, 2010, the boards issued a joint Exposure Draft entitled: *Proposed Accounting Standards Update: Leases*. An exposure draft represents a proposed standard. It is the result of a continuing project (in this case, leases), and the boards invite individuals and organizations to provide comments, insight, and opinions expressing agreement or disagreement on any matters within the draft in order to take their next step in the lengthy standard setting process. The draft aims to require capitalization of all real estate and equipment leases on balance sheets by recognizing the rights and obligations of lessees. While the change to lessee accounting is much more significant, the exposure draft considers accounting by lessors as well. In addition to the changes for lessee accounting, the proposed approaches to lessor accounting would differ significantly from GAAP and IFRS as well (Henry, E. and Holzmann, O.J., 2011).

For the Lessee

For the Lessee, the exposure draft completely erases the distinction between operating and capital leases. From the start of the lease, the lessee would recognize a right of use asset as well as a liability to make lease payments. Both of these are recorded at the present value of the lease payments, discounted using the lessee's borrowing rate or the rate the lessor chargers if the borrowing rate cannot be determined (Henry, E. and

Holzmann, O.J., 2011). On the lessee's balance sheet, lease liabilities would be presented as a separate item apart from other financial liabilities, and the lease driven assets would be capitalized as property, plant and equipment (PP&E). From the income statement perspective of the financial statements, interest expense on the lease liability would be shown separate from other interest expense, as well as amortization expense for the leased asset would be shown different from other amortization expense (Henry, E. and Holzmann, O.J., 2011). Much of this was done with the old approaches, but not on the actual balance sheets, maybe in their disclosure notes and configured by a research team or analysts. To sum up the new outlook, the proposed lessee accounting reflects what is currently done, but because of the capitalization requirement for all leases, the reporting would now be in a more transparent light.

The Lessor

Within the exposure draft, the proposed amendments to lessor accounting involves identifying if the lessor is going to use the performance obligation approach or the de-recognition approach. This choice is final and once made cannot be changed. Decision of application depends on the degree to which the lessor remains involved with the underlying asset (Henry, E. and Holzmann, O.J., 2011). The performance obligation approach would be applied when the lessor remains vulnerable to risks and benefits intact with the underlying lease either during or after the expected lease term. Under the de-recognition approach, lessor accounting is similar to accounting for a capital lease under current standards, and is applied assuming no significant risks or benefits are associated with the leased asset. Financial presentation under these two methods differs as well. A lessor applying the performance obligation approach would include lease items in a

linked format recognizes the mutually supporting lease related assets and liabilities. The balance sheet would show underlying assets (not derecognized), rights to receive lease payments (measured at present value), lease liabilities (measured at present value), as well as the total of those three as a net lease asset or a net lease liability. The lessor's income statement under the performance approach would also show the linked total net lease income or expense represented by interest income, lease income, and depreciation expense from the underlying asset (Henry, E. and Holzmann, O.J., 2011). The financial statement presentation by a lessor under the de-recognition approach would require reporting of the lease items to be separate from similar items to point out the fundamental differences for the lease related items.

The Discussion

Once submerged in the introduction of the new proposals for lessees and lessors, discussion erupts among interested parties all around the world. One of these said meetings took place in London on Dec 17, 2010. Although much of the exposure draft is focused on lessees, a majority of the critiques came in from lease experts concerning the two approaches for lessor accounting. Jacqueline Mills, representing Lease Europe said of the distinction between the two models, " Assuming the definition of a lease is sufficiently clear and narrow, we think as lessors that the model that goes hand in hand with the right of use model for lessees is the de-recognition model" (Bouvier, 2011, p. 29). Mills goes on to explain that they don't think the performance obligation approach represents economic reality and they have never been able to conceptually understand it. On par with Mills' thoughts, Peter Hogarth representing PricewaterhouseCoopers, suggests that conceptually the de-recognition approach is more consistent than the

performance obligation approach with regards to the right of use model for lessees. Both favor the de-recognition approach but still admit it needs work. Peter Hogarth holds the view that “because the boards objective appears, quite rightly, to focus on lessee accounting, and given the number of priorities that boards have to deal with over the next few months, that maybe lessor accounting should be deferred” (Bouvier, 2011, p. 29). Agreeing with the inconsistency of the proposed changes for lessors is the Institute of Chartered Accountants of England and Wales representative, Jon Blake. Blake stumbles through the conceptual discrepancies of having one model for lessees and two models for lessors (Bouvier, 2011). A differently viewed response to the proposals for lessor accounting came from Trevor Derwin, a partner specializing in lease accounting with Deloitte. Trevor gives the *current* lessor model support when he explains that at the moment, people know it and understand it, so it isn’t that urgent to switch. He goes on more saying, "We don't understand the lessor model that has been proposed, we don't understand what all the assets represent, we don't think that has been clearly articulated” (Bouvier, 2011, p. 30). Jon Blake is in sharp contrast to this idea because he believes leaving lessor accounting as it is endorses inconsistency right away. One of the ruts Blake has with current lessor accounting is where it matches the proposed performance obligation approach in a situation that one asset could potentially show up on both the lessee’s and lessor’s balance sheet. Blake finds it difficult to understand how you could keep the concepts and classifications of finance and operating leases for lessors while changing lessee accounting. Blake proclaims, “I think it is logical that a new standard addresses both lessee and lessor accounting, and I say that as a lessor" (Bouvier, 2011, p. 30).

Lease / Service Arrangement Split

Another significant concern area experts are urging the boards to reconsider is the line of discernment between leases and service arrangements. Paul Pacter, an IASB member, said at a working group meeting on January 7, 2011, that he found it "kind of shocking" that the boards were at the current stage of standard setting on leases despite that fact that "we're not done defining yet what a lease is" (Bouvier, 2011, p. 27). The experts concluded that the line differentiating a lease from a service agreement is not clear-cut enough. Two examples of this controversial line infringement are; season ticket holders for sporting events in which a person is required to occupy a specific seat and the instance of photocopying services where a photocopier is delivered to a company's premises. The truth is, it is not the machine that is important in this circumstance, it is the service delivered through that machine. This is relevant because on cases on the fence between services and leases, they more often than not get shoved in the leases hole. If you can't split the service element up from the right of use asset, you will end up capitalizing the whole payment. Trevor Derwin is a Deloitte partner involved in the discussion and is adamantly advocating the need for separation of the two elements to ensure clarity between a service arrangement which uses assets to deliver the service and a specified asset within a lease (Bouvier, 2011).

Future Outlook

Throughout the controversial lease accounting proposals, FASB members are stressing that fact that the standard setters have not yet made up their mind for the proposed lease accounting remedy. FASB member Lawrence Smith states, "This is not a done deal. We have learned an awful lot throughout fielding comments and in these

outreach efforts" (Burkholder, S., 2011, p. 62). Another FASB member, Russell Golden, encourages feedback as a vital part of the standard setting process when he pleaded, "Spread the word we do listen" (Burkholder, 2011, p. 62). A final standard is set to issued June 2011, with an effective date yet to be determined but likely no sooner than January 2013. With these goals vast approaching and weighing heavy on the minds of the boards' standard setters, they are still striving more to get their actions right, even if it puts a hold on the calendar. One thing is certain, disclosure is not enough. Gerald White, representing the CFA institute, stands firm that footnote disclosure is not an adequate substitute for recording lease-related assets and liabilities in the balance sheet: "Disclosure is not enough, says White, events need to be in the front of the financial statements. Disclosures are not audited with the same kind of rigor as amounts in the financial statements" (Burkholder, 2011, p. 63). Disclosure is not enough.

Conclusion

Committee members and accountants worldwide are consistent in the fact that lease accounting is substantially important for users of financial statements. However, it is also unmistakably clear that accounting for leases is currently plagued with scores of detrimental loopholes which induce many schemes of shrewd management to thwart the spirit and intent of the standard for lease accounting. The most recent exposure draft is a light in a dark hole and is an encouraging step in the right direction. The introduction of the "right-of-use" model should bring more satisfaction than the ownership model which continually worked so poorly in practice. The exposure draft produces a seemingly solid effort towards transparency, but it is not the final product by any means. Issues concerning scope, special-purpose entities, lease term clarifications, discounting, and

executory contracts for services are all still in the blender of concepts that need improvement and revision before we can call accounting for leases a finished product. Ingredients are still being added here and there, but lease accounting is on the right road, going the right direction, now we just need to not run out of gas!

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