

COMMENTARY

The Conceptual Framework and Accounting for Leases

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SYNOPSIS: For years, users of financial statements, academics, and standards setters alike have criticized the lease accounting standards as unnecessarily complex and ineffective in portraying liabilities arising from lease contracts in the balance sheets of lessee enterprises. Recognizing that current standards were adopted before the Financial Accounting Standards Board (FASB) and other standard-setting bodies completed their conceptual framework projects, critics of the lease accounting standards contend that the principal defect in existing standards is that they are at variance with the definitions of assets and liabilities in those frameworks. Some, including the Chairman and several other charter members of the newly formed International Accounting Standards Board (IASB), have called for new lease accounting standards anchored securely in the framework definitions of assets and liabilities. There is not universal agreement, however, on exactly what assets and liabilities result from applying these definitions to a lease contract. For companies that lease a significant amount of physical plant, financial statements produced under the two alternative interpretations explored in this paper are radically different.

This paper proposes a decision model for choosing between two alternative interpretations of the definitions of assets and liabilities in a leasing context, illustrates the effects on the basic financial statements of a lessee enterprise of applying these two alternative interpretations, and evaluates the results using the proposed decision model.

BACKGROUND

Standard setters, academics, auditors, users, and preparers of financial statements have long debated whether or when assets and liabilities result from lease contracts. In a very real sense, a workable method of reporting leases in the financial statements of lessees has been the Holy Grail of accounting standard setters in this country for at least 40 years. Neither the Accounting Research Committee of the AICPA nor the Accounting Principles Board was able to build a consensus for doing anything substantive with this issue.

The newly formed FASB took up the subject of accounting for leases as one of its first priorities and, during the first seven or eight years of its existence, the FASB devoted nearly half of its staff resources to lease accounting issues. The focus of these efforts, Statement of Financial Accounting Standards No. 13, *Accounting for Leases* (FASB 1976,

SFAS No. 13), clearly represents progress when compared to all previous attempts at developing lease accounting standards. Nevertheless, despite multiple revisions including nine FASB amendments, six FASB Interpretations, 12 FASB Technical Bulletins, and EITF consensuses too numerous to count, there is virtually universal agreement that SFAS No. 13 fails to achieve its stated objectives and needs to be reconsidered.

I first became involved in the lease accounting standard-setting process as a young manager in the San Francisco office of KPMG, when I assisted my firm's national office in responding to the two FASB Exposure Drafts that culminated in the issuance of SFAS No. 13 in November 1976. Later, I met annually with the FASB and its staff to discuss FASB projects affecting the leasing industry and assisted in developing industry-specific responses to various FASB proposals to amend SFAS No. 13. Initially I was a member of the Accounting and Finance Committee of the Equipment Leasing Association of America (ELA) and later I served as an Associate Member of the ELA Board of Directors. After transferring to the Department of Professional Practice in KPMG's national office in 1992, I also served for several years on a Working Group formed to advise the EITF on various lease accounting issues. In March 1999, I accepted appointment to the Financial Accounting Standards Advisory Council, which meets quarterly with the FASB and its staff to discuss the Board's current and possible future standard-setting agenda. As auditor of or advisor to lessee and lessor companies, over the past 30 years I have read literally thousands of lease contracts conveying the right to use every conceivable type of equipment and real estate for periods ranging from one day at a time to 75 years or more.

TWO ALTERNATIVE CONCEPTS OF LEASE ACCOUNTING

During the deliberations that preceded SFAS No. 13, some argued that all lease commitments create obligations that should be reflected as liabilities in the balance sheets of lessees. However, the FASB disagreed. The provisions of SFAS No. 13:

derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. (FASB 1976, para. 60)

By preserving in SFAS No. 13 the distinction between operating and capital leases previously articulated in Accounting Principles Board Opinion No. 5 (AICPA 1964), the FASB agreed that some leases give rise to assets and liabilities and others do not.

Following SFAS No. 13's appearance in November 1976, the International Accounting Standards Committee and the standard-setting bodies of Canada, the United Kingdom, Australia, and New Zealand all adopted lease accounting standards patterned after the FASB's approach. Together, representatives from the FASB and these standard-setting bodies comprise the G4+1, an informal organization devoted to furthering the shared standard-setting objectives of their respective participating organizations through analysis and discussion of financial-reporting issues of mutual interest.

In July 1996, the FASB joined with the other G4+1 organizations to publish a Special Report, *Accounting for Leases: A New Approach*. Authored principally by Warren McGregor, at that time Executive Director of the Australian Accounting Research Foundation and,

more recently, a charter member of the new IASB, the so-called “McGregor Report” roundly criticized SFAS No. 13 and the lease accounting standards of the other G4+1 member organizations. According to McGregor (1996), current standards fail to account for the assets and liabilities associated with the rights and obligations that arise out of most “operating” lease contracts. McGregor (1996, 13) called for a “new approach” to account for leases—one that requires lessees to recognize a liability equal to the present value of their unavoidable rent obligations for *all* leases having initial noncancelable terms greater than one year.

In February 2000, the FASB and other G4+1 organizations jointly published a second Special Report, *Leases: Implementation of a New Approach*, for which Hans Nailor and Andrew Lennard are the principal authors. This document contains detailed proposals for incorporating McGregor’s “new approach” into a comprehensive new lease accounting standard.

A majority of the participants in the second study concluded that each separate right arising out of a lease contract represents an asset and each separate obligation represents a liability that lessees need to recognize and account for individually. Under this approach, at the commencement of a lease, lessees record an asset and liability equal to the present value of the committed rental payments *and* an asset and a liability equal to the fair value of any renewal option, residual value guarantee and/or contingent rent provisions in the lease (Nailor and Lennard 2000, 30–32). Where fair values are not readily observable, they must be estimated. In this paper, I refer to the approach supported by the majority of G4+1 participants as the *financial components approach*.

Alternatively, a minority of participants in the G4+1 second study believes that the asset that results from entering into a lease contract is the leased property itself. Under this approach, liabilities arising from lease contracts include not only the obligation to pay rent over the lease term, but also the obligation to return the leased property to the lessor at the end of the lease term unless the lease is renewed or extended (Nailor and Lennard 2000, 24–25). In this paper, I refer to the G4+1 minority view as the *whole asset approach*.

These two approaches to identifying assets and liabilities associated with a lessee’s rights and obligations under a lease produce very different balance sheets and income statements for entities that lease significant amounts of property, plant, and equipment. Therefore, when the FASB eventually undertakes a project to reconsider the accounting for leases, I believe it will need to choose between these two approaches.

THE FASB’S CONCEPTUAL FRAMEWORK— A CONCEPTUAL MODEL FOR CHOOSING

Two years after issuing SFAS No. 13, the FASB issued the first of a series of Statements of Financial Accounting Concepts. During the ensuing decade, the FASB exposed, debated, and eventually adopted five more Concepts Statements. Collectively, these Concepts Statements constitute a financial-reporting conceptual framework intended to guide the Board as it develops future accounting standards. Throughout the 1980s, each of the other G4+1 organizations developed its own version of a conceptual framework, patterned in most respects after the FASB’s framework. Since they adopted their conceptual frameworks, all member organizations of the G4+1 increasingly have focused their standard-setting activities on the balance sheet, guided by their respective framework’s definitions of assets and liabilities.

FASB (1985) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, provides the following definitions of assets and liabilities:

- *Assets* are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events (FASB 1985, para. 25).
- *Liabilities* are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events (FASB 1985, para. 35).

The assets and liabilities to be identified and accounted for under both the *financial components approach* and the *whole asset approach* satisfy the literal language of these definitions. So how should standard-setters choose between them? I believe the answer lies in a comparison of the accounting information that each approach produces using qualitative criteria contained within the FASB's own conceptual framework.

In FASB (1980) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (CON 2), the Board examined the qualitative aspects of accounting information. It concluded that the selection of *preferred* accounting policies from among alternatives should be guided by the characteristics that make information a desirable commodity. These characteristics can be viewed as a hierarchy of qualities with *decision usefulness* being most important. The primary qualities that make accounting information useful are that it is *relevant* and *reliable*. To be relevant, accounting information must be timely and it must have predictive value, feedback value, or both. To be reliable, such information must be *representationally faithful*, *verifiable*, and *neutral*. In addition, *comparability*, including *consistency*, is a secondary quality that interacts with relevance and reliability to improve the usefulness of accounting information (FASB 1980, paras. 32–33).

CON 2 describes representational faithfulness as:

correspondence or agreement between a measure or description and the phenomenon it purports to represent. In accounting, the phenomena to be represented are economic resources and obligations and the transactions and events that change those resources and obligations....(FASB 1980, para. 63)

Thus, financial statements prepared in accordance with generally accepted accounting principles are representationally faithful to the extent that they provide an objective picture of an entity's resources and obligations—a *reality that exists in the physical world*.

CON 2 also advises that:

Information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other point in time. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark....(FASB 1980, para. 111)

This statement reflects the Board's understanding that the predictive and feedback values underlying relevance depend on the extent to which accounting information can be employed to make meaningful comparisons from period to period or from enterprise to enterprise.

I do not believe it is possible to demonstrate in the abstract that the FASB's definitions of assets and liabilities are being misinterpreted under either the *financial components approach* or the *whole asset approach*. However, the conceptual framework tells us that the interpretation of those definitions that produces the more decision-useful information—the more relevant, reliable, and comparable financial statement results—should be the interpretation that is preferred. Therefore, I propose to apply that standard in choosing between these two approaches.

THE ROLE OF LEASING IN A MARKET ECONOMY

In order to apply their conceptual frameworks to the development of new authoritative literature, standard setters need a context within which to assess the decision-usefulness of accounting information. For lease accounting standards, I believe that context resides in the role that leasing plays in a modern market economy.

Historically, the leasing industry has developed products designed to satisfy economic needs. Principal economic reasons for the existence of leasing include:

- to intermediate the risk of owning property;
- to finance the acquisition of property, plant, and equipment;
- to enable users of property to conserve working capital as compared to more traditional financing arrangements;
- to intermediate credit risk between sub-prime credits and traditional lending institutions;
- to intermediate the transfer of income tax benefits associated with owning property from low marginal-rate tax payers to higher-rate tax payers; and
- to outsource significant activities related to the maintenance and administration of property, plant, and equipment to specialists.

Property ownership exposes owners to risks when prices fluctuate because of changes in technology or supply and demand. If an enterprise needs property to conduct its operations, not owning property exposes entities to these same risks, albeit in reverse. Ownership risks that lessors intermediate include the risks associated with (1) purchasing a long-lived asset to satisfy a short-term need, (2) purchasing an asset subject to technological obsolescence, (3) having revenue-generating equipment sit idle during off-peak periods, and (4) owning more property than one needs. Owning an entire high-rise office building to get a downtown address when the entity only needs one floor is an example of this last risk. Throughout the economy, specialty lessors operate in response to the demand of some property users for products that mitigate or manage these risks in relation to future plans and expectations.

Whether they choose to own or lease their physical plant, property-intensive enterprises must finance their fixed asset acquisitions. They have a variety of alternatives from which to choose and they must decide between short- or long-term and fixed- or variable-rate financing. These decisions also create opportunity for economic gains and exposure to economic losses when the general level of interest rates changes in response to fluctuations in the supply of and demand for money.

In addition to the *economic* reasons for leasing, many lessees prefer leases over other financing products to obtain an off-balance-sheet accounting presentation that they consider desirable. The volume of leases in our economy employed primarily to take advantage of such perceived financial-reporting benefits has increased significantly each year since SFAS No. 13 was adopted, as lessors design and market new structures

to meet customer demand for such products. For example, the so-called *synthetic lease* structure that exists among users of vehicle fleets at least since the late 1970s was adapted successfully to the off-balance-sheet financing of large real estate facilities in the 1990s, producing geometric growth in the volume of such transactions over the last ten years. This growing volume of transactions motivated primarily or exclusively by accounting objectives represents yet another measure of the extent to which SFAS No. 13 fails to live up to its billing.

IMPLICATIONS FOR ACCOUNTING STANDARDS

In my experience, users of financial statements want information to help them assess the nature and extent to which an enterprise is exposed to risk or positioned to benefit from changes in the price of the principal inputs and outputs that drive its operations. For capital-intensive enterprises, those inputs include both property-acquisition and financing costs. Various leasing strategies expose lessees to varying degrees of property and interest rate market risks. Thus, an accounting approach that provides more relevant, reliable, and comparable information about where an enterprise is positioned on this risk and benefit continuum should be preferred, according to my proposed decision model.

However, balance sheets and income statements contain specific amounts, not ranges, and it is difficult if not impossible to translate information about exposure to fluctuating property values into single numbers reported in balance sheets and income statements. Therefore, neither the financial components approach nor the whole asset approach to identifying the assets and liabilities that belong on lessee balance sheets can provide information about such exposures even if users consider it to be decision-useful. Under either approach users of financial statements must rely on footnote disclosures and other sources to obtain information on this subject. Therefore, the need to communicate such information to financial statement users cannot serve as the basis for preferring one of these balance sheet approaches over the other.

On the other hand, in my experience users of financial information rely on amounts reported in financial statements to analyze relationships having the kind of predictive and feedback value that the FASB's conceptual framework attributes to decision-useful accounting information. For example, lenders use such metrics as debt to equity, interest coverage, and current ratios to assess the short- and long-term creditworthiness of current or prospective customers. Equity investors use return on assets and revenue per dollar of fixed assets to measure the efficiency with which a company employs its resources and to compare a company's current performance with that of prior periods or with other companies and industries. The extent to which such analyses lead to different conclusions about the creditworthiness or performance of a lessee due to data differences that result entirely from selecting one accounting convention over another bears directly on the relevance of the data being analyzed. Therefore, I suggest that evaluating the decision-usefulness of financial information derived from lessee balance sheets and income statements prepared under the *financial components* and *whole assets approaches* can provide standard-setters with a meaningful basis for preferring one of these approaches over the other.

COMPARING THE FINANCIAL STATEMENT EFFECTS OF THE TWO APPROACHES

Exhibit 1 compares the incremental effects on an airline's balance sheets and income statements of leasing a \$100 million airplane for three years and accounting for it under

EXHIBIT 1
Comparison of the Financial Components
and Whole Asset Approaches

Panel A: Incremental Partial Lessee Balance Sheets for a Three-Year Lease
(end of Years 1 and 3)

| | Year 1 | | Year 3 | |
|---|---|----------------|-------------------------|----------------|
| | Financial Components | Whole Asset | Financial Components | Whole Asset |
| Assets | (000s and ignoring income taxes) | | | |
| Cash | (10,500) | (10,500) | (31,500) | (31,500) |
| Property, plant, and equipment | 26,579 | 100,000 | 26,579 | 100,000 |
| Less: accumulated amortization | (8,860) | (1,639) | (26,579) | (4,917) |
| Net property, plant, and equipment | 17,719 | 98,361 | 0 | 95,083 |
| Total assets | 7,219 | 87,861 | (31,500) | 63,583 |
| Liabilities and Shareholders' Equity | | | | |
| Long-term debt, current portion | 9,633 | 1,635 | 0 | 95,083 |
| Long-term debt (excluding current portion) | 8,838 | 96,865 | 0 | 0 |
| Retained earnings (ignoring taxes) | (11,252) | (10,639) | (31,500) | (31,500) |
| Total liabilities and equity | 7,219 | 87,861 | (31,500) | 63,583 |

Panel B: Incremental Partial Lessee Income Statements for a Three-Year Lease
(Years 1 and 3)

| | Year 1 | | Year 3 | |
|---------------------------------|---|----------------|-------------------------|----------------|
| | Financial Components | Whole Asset | Financial Components | Whole Asset |
| Assets | (000s and ignoring income taxes) | | | |
| Operating expenses: | | | | |
| Depreciation and amortization | (8,860) | (1,639) | (8,860) | (1,639) |
| Operating income | (8,860) | (1,639) | (8,860) | (1,639) |
| Interest expense (at 9 percent) | (2,392) | (9,000) | (867) | (8,718) |
| Net income (ignoring taxes) | (11,252) | (10,639) | (9,727) | (10,357) |

each of the two approaches. Annual rents of \$10.5 million are due in arrears and the lessee's incremental borrowing rate at the inception of the lease is 9 percent per annum.

Under the financial components approach, at lease commencement the lessee records an asset and liability equal to the present value of three payments of \$10.5 million, discounted at 9 percent per annum. Interest is imputed to the recorded liability at 9 percent and the difference between imputed interest and the total annual payment is a reduction of the liability. The lessee amortizes the recorded asset to depreciation expense over the three-year lease term with no salvage value.

Under the whole asset approach, at lease commencement a lessee records an asset equal to the \$100 million fair value of the airplane and a corresponding liability consisting of the combined obligations to make lease payments and to surrender the airplane to the lessor in three years. As with the financial components approach, interest is

imputed to the recorded liability at 9 percent per annum and the difference between imputed interest and the annual lease payment is treated as a reduction of the liability. The lessee amortizes the recorded asset to depreciation expense over the three-year lease term, assuming a salvage value equal to the recorded liability to return the airplane in three years, \$95.083 million.

As expected, the assets and liabilities reported in a balance sheet prepared under the whole asset approach are significantly higher than those in a balance sheet prepared under the financial components approach. Note also that the whole asset approach reclassifies the obligation to return the airplane into current liabilities during the last year of the lease. Users of the airline's financial statements now see that the company either must refinance this asset at current market rates within the year or surrender it, thereby losing access to a significant source of revenue. The financial components balance sheet provides no such information.

The effects on the income statement are even more dramatic. Although the expense to be reported is identical in the aggregate over the three years, and differs from year to year by only plus or minus 6 percent, differences in the classification of reported expenses are much greater in ways very significant to the company's reported operating income and interest expense. Over the three-year period, the financial components approach reports almost 85 percent of the total payments as depreciation of fixed assets with only 15 percent reported as interest. Under the whole asset approach the airline reports depreciation equal to 16 percent of aggregate payments over the three-year period while reporting 84 percent as interest.

ASSESSING THE RELEVANCE AND RELIABILITY OF THE INFORMATION

The differences in financial statement presentation illustrated in Exhibit 1 impact the reporting entity's debt-to-equity ratio, its computed return on assets, its revenue per dollar invested in fixed assets, its current ratio, and its interest coverage and earnings to fixed-charges ratios. For an enterprise that leases substantial quantities of real estate and/or equipment this impact is significant. It cannot be the case that such radically different numerical representations of the same event in the basic financial statements can produce information with equally useful predictive value and feedback value.

According to the conceptual framework, the approach that produces the more *relevant* information is the approach that produces the more *reliable* information and promotes the more meaningful comparisons of information between periods or between a company and its competitors. Furthermore, in order to be reliable, accounting information must be *representationally faithful* to the phenomenon it purports to represent.

By focusing on each individual right and obligation written into a lease contract as a separate asset or liability, the financial components approach carves up leased tangible property, plant, and equipment that companies use to conduct their business in the physical world into intangible abstractions bearing little relationship to the physical realities they purport to represent. Under the financial components approach, the asset an airline uses to generate revenue is an airplane only when it purchases the airplane. Otherwise, its flight equipment assets consist of intangible rights, measured as the unamortized present value of initial firmly committed rents and estimated fair values of options, guarantees, and contingent rents included in the lease contract.

The variety of such assets that lessees could and would report in their balance sheets is unlimited. These intangibles neither describe a reality that exists in the physical world nor provide a reliable means to compare the performance of entities that use

different strategies to finance their physical plant. In my opinion, the financial components approach subordinates the definition of an asset to an interpretation of the definition of a liability biased toward recognizing future obligations to pay cash.

Under the whole asset approach, the economic benefit an airline controls under a lease is an airplane. This interpretation conforms what is reported as an asset in the airline's balance sheet to the tangible reality of the physical world, regardless of whether the airline leases or purchases its flight equipment. Under this approach, the lessee's obligation to return the airplane to the lessor at the end of the lease term is one of the liabilities arising out of the contract. This interpretation is entirely consistent with the Board's definition of a liability if one starts with the assumption that the asset is the entire leased property.

A majority of the G4+1 argue that the lessee's rights only relate to a part of the economic benefit represented by the leased property and that, accordingly, the recognized asset should not be characterized as the whole asset. They assert that the obligation to return the property at the end of the lease does not meet the definition of a liability because the economic benefits relating to the property beyond the term of the lease were not transferred to the lessee in the first place.

This argument has a certain circularity to it, resting as it does on the contention that only a portion of the asset was transferred in the first place. However, it is indisputable that when an airline flies passengers between New York and Los Angeles, it flies a whole airplane, not a bundle of intangible rights. Indeed, throughout the term of the lease, the resource a lessee airline controls is an airplane. That is the physical reality and in my view, accounting that does not portray that reality is not representationally faithful.

It also is indisputable that every lease enables the lessee to finance the acquisition of property, plant, or equipment. Whatever else we know or believe about lease contracts, we can be fairly confident that some lessor is paying interest on a significant portion of the purchase price of the leased property. We also can be fairly certain that the rent the lessor demands in exchange for surrendering control over its airplane is sufficient to recover its financing costs, including a return on any of its own money invested in the property, plus any expected decline in the market value of the property itself.

Yet the financial components approach reports a disproportionate amount of the expense resulting from all but the longest-term leases as depreciation expense. It does not appear to be representationally faithful that the split between the portion of each rental payment reported as interest and the portion reported as depreciation expense is a function of the length of the lease term. Furthermore, accounting that ignores the inherent financing nature of lease contracts and reports what clearly are financing costs as depreciation charges can hardly be said to correspond faithfully to the phenomenon it purports to represent.

The Concepts Statements tell us that to be reliable, information also must be verifiable. The financial components approach described in the second G4+1 Special Report requires lessees to estimate and account for each separate financial component. Thus, lessees must estimate the fair value of residual value guarantees, renewal options, and contingent rent provisions. In many, if not most, situations there is no observable market that validates the lessee's estimates of fair value for these provisions. Therefore, these estimates will be substantially unverifiable. But to do the accounting under the whole asset approach, one need only determine the fair value of the leased property,

the term of the lease, and the lessee's incremental borrowing rate at the lease inception. All these latter variables are readily available as they currently are necessary in order to classify and account for leases under SFAS No. 13.

Finally, in my opinion, any new lease accounting standard that does not reduce the volume of lease contracts transacted solely or primarily to take advantage of the perceived benefits of off-balance-sheet financing must be producing information that is neither relevant nor reliable. Such a standard is not worth the time and effort required to develop and maintain it. However, if the financial components approach is adopted in its conceptually pure form, as described in the second G4+1 Special Report, then the financial components approach puts even more variables in play. As a result, I believe the opportunities in the reconfigured landscape of the new standard to structure for perceived accounting advantage will increase, not decrease, and if the opportunities are there, then lessees and lessors will find and use them. Our experience with SFAS No. 13 indicates that standard setters and regulators will spend virtually unlimited hours attempting to fashion increasingly arbitrary rules having little or no underlying theoretical basis. These will be needed to curb perceived accounting abuses and to stem the migration of even more assets and related financing obligations off of corporate balance sheets.

COMPARING THE EFFECTS OF THE FINANCIAL COMPONENTS APPROACH TO A PURCHASE

Exhibit 2 illustrates the incremental balance sheets and income statements of three airlines, using the financial components approach, prepared one year after acquiring a \$100 million airplane. The first airline acquired its equipment under the three-year lease illustrated in Exhibit 1. The second airline entered into an 18-year lease requiring annual rents of \$9.330 million and has an incremental borrowing rate of 7.75 percent. Finally, the third airline purchased its airplane with a \$15 million down payment and the \$85 million proceeds from a 22-year, 7.5 percent loan requiring annual principal and interest payments of \$8.006 million. It depreciates its airplane over 35 years to an estimated salvage value of \$15 million. All periodic payments are due in arrears.

Although the financial components approach produces nontrivial differences between the 18-year lease and the purchase, at least the reported information bears some relationship to the underlying financing nature of the transaction. However, the differences between either of these transactions and the three-year lease make meaningful comparisons of the performance of these three airlines virtually impossible without engaging in significant recasting of the short-term lessee's financial statements. From this simple example, it should be apparent that financial statements prepared under the financial components approach that contain significant assets and liabilities arising from numerous leases, each with a different initial and remaining term, will be hard to interpret. Users will find it even more difficult to decipher the physical reality of the resources an entity controls in order to make comparisons between or among companies. Similarly, analysts will find the financial ratios derived from such balance sheets and income statements to be substantially useless for comparison purposes until they recast the basic statements, just as they do today to adjust for operating leases, in an effort to simulate the information reported under the whole asset approach.

EXHIBIT 2
Comparison of a 3-Year Lease, an 18-Year Lease, and a Purchase
under the Financial Components Approach

Panel A: Incremental Partial Lessee Balance Sheets (end of Year 1)

| | <u>3-Year</u> <u>Lease</u> | <u>18-Year</u> <u>Lease</u> | <u>Purchase</u> |
|---|-------------------------------|--------------------------------|-----------------|
| Assets (000s and ignoring income taxes) | | | |
| Cash | (10,500) | (9,330) | (23,006) |
| Property, plant, and equipment | 26,579 | 88,977 | 100,000 |
| Less: accumulated amortization | (8,860) | (4,943) | (2,429) |
| Net property, plant, and equipment | <u>17,719</u> | <u>84,034</u> | <u>97,571</u> |
| Total assets | <u>7,219</u> | <u>74,704</u> | <u>74,565</u> |
| Liabilities and Shareholders' Equity | | | |
| Long-term debt, current portion | <u>9,633</u> | <u>2,623</u> | <u>1,753</u> |
| Long-term debt (excluding current portion) | <u>8,838</u> | <u>83,920</u> | <u>81,616</u> |
| Retained earnings | <u>(11,252)</u> | <u>(11,839)</u> | <u>(8,804)</u> |
| Total liabilities and equity | <u>7,219</u> | <u>74,704</u> | <u>74,565</u> |

Panel B: Incremental Partial Lessee Income Statements (Year 1)

| | <u>3-Year</u> <u>Lease</u> | <u>18-Year</u> <u>Lease</u> | <u>Purchase</u> |
|---|-------------------------------|--------------------------------|-----------------|
| Assets (000s and ignoring income taxes) | | | |
| Operating expenses: | | | |
| Depreciation and amortization | <u>(8,860)</u> | <u>(4,943)</u> | <u>(2,429)</u> |
| Operating income | <u>(8,860)</u> | <u>(4,943)</u> | <u>(2,429)</u> |
| Interest expense | <u>(2,392)</u> | <u>(6,896)</u> | <u>(6,375)</u> |
| Net income (ignoring taxes) | <u>(11,252)</u> | <u>(11,839)</u> | <u>(8,804)</u> |

**COMPARING THE EFFECTS OF THE WHOLE ASSET
APPROACH TO A PURCHASE**

Exhibit 3 illustrates the incremental income statements and balance sheets for the same three airlines prepared by applying the whole asset approach to the same three financing transactions. Salvage value assumed at the end of the 18-year lease is \$42,248 million. Differences in the information prepared under the whole asset approach can be explained in terms that relate to the underlying differences in the three financing strategies. For example, differences in interest expense between the three-year lease and the longer-term financing structures can be explained primarily as the difference between short- and long-term interest rates. Differences in depreciation expense between the 18-year lease and the purchase can be explained as the risk premium the lessee is paying the lessor to assume the residual risk at the end of the lease term. The lower

EXHIBIT 3
Comparison of the Financial Components
and Whole Asset Approaches

Panel A: Incremental Partial Lessee Balance Sheets (end of Year 1)

| | <u>3-Year</u> <u>Lease</u> | <u>18-Year</u> <u>Lease</u> | <u>Purchase</u> |
|---|---|--------------------------------|-----------------|
| Assets | (000s and ignoring income taxes) | | |
| Cash | (10,500) | (9,330) | (23,006) |
| Property, plant, and equipment | 100,000 | 100,000 | 100,000 |
| Less: accumulated amortization | (1,639) | (3,208) | (2,429) |
| Net property, plant, and equipment | <u>98,361</u> | <u>96,792</u> | <u>97,571</u> |
| Total assets | <u>87,861</u> | <u>87,462</u> | <u>74,565</u> |
| Liabilities and Shareholders' Equity | | | |
| Long-term debt, current portion | <u>1,635</u> | <u>1,702</u> | <u>1,753</u> |
| Long-term debt (excluding current portion) | <u>96,865</u> | <u>96,718</u> | <u>81,616</u> |
| Retained earnings | <u>(10,639)</u> | <u>(10,958)</u> | <u>(8,804)</u> |
| Total liabilities and equity | <u>87,861</u> | <u>87,462</u> | <u>74,565</u> |

Panel B: Incremental Partial Lessee Income Statements (Year 1)

| | <u>3-Year</u> <u>Lease</u> | <u>18-Year</u> <u>Lease</u> | <u>Purchase</u> |
|-------------------------------|---|--------------------------------|-----------------|
| Assets | (000s and ignoring income taxes) | | |
| Operating expenses: | | | |
| Depreciation and amortization | (1,639) | (3,208) | (2,429) |
| Operating income | (1,639) | (3,208) | (2,429) |
| Interest expense | (9,000) | (7,750) | (6,375) |
| Net income (ignoring taxes) | <u>(10,639)</u> | <u>(10,958)</u> | <u>(8,804)</u> |

level of interest and aggregate expense reported by the purchaser can be explained as the result of its having financed only 85 percent of the purchase price as compared to the 100 percent financing implicit in the lease arrangements. Differences in performance metrics such as interest coverage ratios and EBITDA reflect differences in the total financing implicit in the lease and in the total fixed asset base an entity uses to conduct its business. No matter how many leases an enterprise enters into, its financial statements will present reliably the property, plant, and equipment resources it controls and the depreciation expense and interest associated with using and financing those resources. Likewise, financial statement ratios prepared from each of the entity's financial statements can be compared without the need to recast or modify them to put them on a comparable basis.

CONCLUDING COMMENTS

The FASB's conceptual framework commits the Board to develop financial accounting standards for the primary purpose of providing information useful to capital market participants for making investment decisions and allocating resources. When the FASB eventually reconsiders accounting for leases, it must decide how its definitions of assets and liabilities should be applied to the rights and obligations arising out of lease contracts. I believe that the qualitative characteristics articulated in CON 2 that make accounting information a desirable commodity should guide the Board in making that decision. For the reasons set forth above, measured against the criteria of the conceptual framework, I believe the case is overwhelming for the superiority of the whole asset approach over the financial components approach.

The focus of this paper is accounting by lessees for leases of equipment. I did not attempt to address the significant lessor accounting issues to be resolved before any new lease accounting standard is adopted. I also did not address the significant issues surrounding the accounting for sale-leaseback transactions, sublease arrangements, and leases of real estate, particularly those involving the use of part of a facility, each of which presents its own unique problems.

Finally, even after the FASB decides on an approach, it seems unlikely that it will adopt a standard requiring lessees to record assets and liabilities for every lease. Cost/benefit considerations alone suggest that leases with very short terms should not be subject to capitalization on lessees' balance sheets. In effect, some leases will continue to be accounted for much as operating leases are accounted for today. SFAS No. 13 attempts, albeit unsuccessfully, to distinguish between capital and operating leases based upon an analysis of residual risk. McGregor (1996) originally suggested not capitalizing leases with initial noncancelable terms less than one year. Nailor and Lennard (2000) suggest only recording assets and liabilities for those rights and obligations that are material—whatever that means. The cost/benefit analysis and other practical considerations that should enter into the resolution of this issue are beyond the scope of this paper. However, notwithstanding the failure of SFAS No. 13 to achieve its stated objectives, I believe a model that incorporates risk into the determination of which leases need not be capitalized is likely to produce an answer that is most representationally faithful to the underlying reasons that leasing exists in our economy. And so the debate continues.

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