ACCOUNTING FOR OPERATING LEASES

The importance of off-balance sheet accounting

Research shows operating leasing should be properly accounted for in lease accounting

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Following two proposals published in 1996 and 2000 to change the lease accounting standard, both FASB and IASB voted in July 2006 to put leasing reform back on the agenda. According to FASB member Leslie Seidman: "Reworking FAS13 ranks second behind pension accounting as one of FASB's top priorities."

As with the previous proposals, the standard setters will jointly propose to eliminate the differences between financial and operating leases, which most likely will lead to the recognition of all leases on the balance sheet. The off-balance sheet character of operating lease is, however, still an important determinant of the operating lease decision and eliminating this aspect might be a significant threat to the leasing industry.

It is often argued that users of the financial statements (including financial analysts) do consider the operating lease commitments when analysing the financial strength of a company. In order to do so, the analyst should calculate an on-balance equivalent (the present value) of the operating leases, as if the lease was treated as a financial lease from the beginning ('capitalisation').

However, in my presentation at Leaseurope's annual congress, I showed that this is not as easy as it seems, and this might be another reason for users of the financial statements to complain about the current lease accounting standard. Eliminating the difficulties with the capitalisation procedures, and providing the standard setters with an alternative lease accounting treatment, might lead to the preservation of the off-balance sheet character of operating leases and prevent a major decline in leasing businesses.

Levels of compliance with the lease accounting standard

Until 2005, in the Netherlands, Guideline 292 was applicable. This is identical to IAS17 in terms of disclosure requirements. However, when analysing the operating lease commitments in 2004 of 109 listed companies, I came across eight different formats of operating lease disclosures.

Of these eight formats, only three complied with IAS17, these companies disclosed:

- First, according to FAS13 (nineteen companies),
- Second, less than FAS13 but more than IAS17 (four companies) and
- Third, as required by IAS17 (44 companies).

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Together with the non-leasing companies (six companies), 67 per cent of the 109 companies complied with the lease accounting standard. The remaining 33 per cent did not comply with the leasing standard, these companies disclosed (with decreasing informativeness):

- First, the present value of the lease commitments (five companies),
- Second, the total commitment not divided over the expiry periods (six companies),
- Third, the annual payment with an indication of the remaining life (eight companies),
- Fourth, the annual payment without remaining life (four companies), and
- Fifth, combinations of the above not-allowed formats (thirteen companies).

The user of the financial statements cannot calculate the present value of the operating lease commitments for companies that do not comply with the lease accounting standard (with, of course, an exception for companies that disclose the present value themselves). Consequently, the commitments cannot be taken into account when analysing such a company. It also explains why no financial database has operating lease commitments completely available for financial analyses, and only manually distracted operating lease commitments allow the financial analyst to consider these commitments.

Impact on key financial ratios

Studies in the US, the UK, Australia and Canada showed that the impact of the capitalisation of the operating lease commitments can have a major impact on key financial ratios. Also, in the Netherlands, the operating lease commitments are of a material amount. In a survey of usage of operating leases by 75 companies for which the present value is known, for 41 companies the operating lease commitments are of a material amount. For 13 companies the present value of the operating lease commitments even exceeds 20 per cent of total assets. Ignoring these commitments would seriously distort the financial analysis of these companies.

Adjusting the financial ratios, total-debt-to-total-assets and total-debt-to-equity, with these commitments (including the adjustment of the related leased asset), results in an average increase of these ratios with respectively 32 per cent and 49 per cent. Return-on-assets decreases on average with eight per cent. These results are in line with studies in the US, the UK and Australia.

Conclusion and recommendations

The above shows that operating leases cannot be ignored when analysing the financial position of a company. This could easily lead to the conclusion that the proposed lease accounting standard to recognise all leases on the balance sheet is desirable. However, an intermediate solution might be worthwhile to consider as well. The lease accounting standard should enhance an "as smoothly as possible" incorporation of the operating lease commitments in the financial analysis of a company.

Therefore, compliance with the lease accounting standard should be enforced and supervised. Insufficiently complete information does not enhance the effortless incorporation of operating leases in the financial statements. Second, the impact of the operating leases on financial ratios is sensitive to the chosen discount rate and the chosen capitalisation procedure. Therefore, the lease accounting standard should require the lessee to disclose the present value of the operating lease commitments instead of the currently required disclosure of the nominal commitments.

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