**IMPACT OF OPERATING LEASES**

The effect on the financial statements of operating versus capital lease treatment can be significant. Consider the lease accounting impact on two ratios—debt-to-equity (liabilities/equity) and asset turnover (sales/assets)—for the following four companies in 2001, shown below:

<table>
<thead>
<tr>
<th></th>
<th>Reported Debt-to-Equity Ratio</th>
<th>Debt-to-Equity Ratio With Operating Leases Capitalized</th>
<th>Reported Asset Turnover</th>
<th>Asset Turnover with Operating Leases Capitalized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wal-Mart</td>
<td>1.38</td>
<td>1.50</td>
<td>2.63</td>
<td>2.51</td>
</tr>
<tr>
<td>McDonald's Home Depot</td>
<td>1.38</td>
<td>1.96</td>
<td>0.66</td>
<td>0.53</td>
</tr>
<tr>
<td>Home Depot</td>
<td>0.46</td>
<td>0.65</td>
<td>2.03</td>
<td>1.79</td>
</tr>
<tr>
<td>FedEx</td>
<td>1.26</td>
<td>2.57</td>
<td>1.47</td>
<td>0.93</td>
</tr>
</tbody>
</table>

The adjusted numbers were estimated using financial statement disclosures discussed later in this chapter. The debt-to-equity ratio is a measure of a company’s leverage, and the asset turnover ratio is a measure of a company’s efficiency in using its assets to generate sales. In each case, the operating lease treatment used by the companies makes them appear less leveraged and more efficient.

With the issuance of FASB Statement No. 13, it was thought that financial statements would reflect the economic reality of firms’ lease agreements. However, the lease standard has been relatively ineffective in meeting its objective. Instead of complying with the spirit of the standard, firms have gone to great lengths to structure leases that do not meet the criteria for balance sheet recognition. In an attempt to keep ahead of the clever manipulations employed by firms to avoid capital lease treatment, the FASB has had to amend and interpret the lease standard more than a dozen times. Scanning the list of FASB pronouncements following the issuance of Statement No. 13, it can be seen that portions of Statement No. 13 have been amended or superseded by Statements Nos. 17, 22, 23, 26, 27, 28, 29, 34, 71, 77, 91, 96, 98, 109, and 125. In addition, the FASB has released Interpretations 19, 21, 23, 24, 26, and 27 and issued 10 Technical Bulletins to clarify certain aspects of the lease standard. In spite of all this, firms still manage to treat the large majority of their long-term, noncancelable leases as off-balance-sheet operating leases.

**QUESTIONS:**

1. If a major objective of financial statement information is to provide useful information to investors and creditors, are those groups currently receiving financial statements that contain relevant and reliable information regarding leased assets?
2. Do you think that the FASB has achieved its objective of requiring leases that are economically equivalent to purchases to be recognized in the balance sheet?
3. It often seems that whenever the FASB provides detailed rules for applying a specific standard, companies spend a great deal of time looking for loopholes in those rules. What can the FASB do to get companies to comply with the intent of a standard?
4. If the FASB were to ask you for advice in revising its standard on leasing, what would your advice be?
SYNTHETIC LEASES

The company was growing exponentially: Sales were up 27% and earnings were up a whopping 73% in the preceding year. This rapid growth had strained the limit of the company’s financing sources. To provide new financing, the company turned to an accounting gimmick called a *synthetic lease*. A synthetic lease is basically an operating lease in which the lessor is a special purpose entity (SPE). Because the SPE is not really an independent party but is set up under the supervision of the lessee, synthetic leases have been viewed as a way to finance the acquisition of an asset and then lease it from yourself, with the end result being that the asset, and the financing, are off your balance sheet. So, what shady company resorted to such accounting trickery to finance its growth? Was it Enron? WorldCom? No, this synthetic lease arrangement was proposed as a way to finance construction of a $35 million distribution facility for Krispy Kreme, the rapidly expanding chain of doughnut shops. When investors and analysts expressed concern that Krispy Kreme was resorting to the same type of off-balance-sheet financing that had become linked in the public mind with Enron, Krispy Kreme announced, “While this type of lease is both common and complies with the most rigorous accounting standards, the Company said today it will instead use conventional, on-balance sheet financing on the $35 million facility. … In the current economic climate, investors understandably are paying closer attention to the financial strength of their companies. There is no reason for us to do anything that could be misinterpreted, regardless of how legal and acceptable it may be.”

Krispy Kreme is not the only company backing away from synthetic leasing these days. In its 2001 10-K filing, General Motors was careful to state: “All of the SPEs established to facilitate property leases to GM are owned by institutions which are truly independent of, and not affiliated with, GM.” General Motors felt that this statement was necessary because the synthetic leases and other SPE-related transactions entered into by Enron have come under fire because the SPEs were not “truly independent” of Enron. Some of the most prominent of the Enron SPEs were financed and run by a man who at the same time served as Enron’s chief financial officer.

With Enron, it was really the fact that the SPEs were established by a related party (the CFO) that made the SPEs and the synthetic leases deceptive. The question is whether a synthetic lease set up strictly according to both the spirit and the letter of the accounting rules is deceptive. Work through the following example and decide whether you think that the accounting for synthetic leases represents honest or deceptive accounting.

**Synthetic Lease Example**

*The Players*

- **Lessee-User.** This is a large company that needs a building costing $100,000 and plans to use a synthetic lease to finance the “acquisition” of the building. The building has a 30-year useful life.
- **Lessor-SPE.** This is a small company that is established with the assistance of Lessee-User to obtain the financing for and buy the building. Lessor-SPE exists for only this purpose; it conducts no other business.
- **Private Investor.** This is an independent third party who invests $3,000 in Lessor-SPE. Private Investor is the legal owner of Lessor-SPE.
- **Bank.** This bank loans $97,000 to Lessor-SPE. The interest rate is 10%. Only interest (no principal) is to be paid on the loan for the first five years. Together with the $3,000 invested by Private Investor, Lessor-SPE can now buy the
$100,000 building. The $97,000 loan to the small company Lessor-SPE is
guaranteed by the big company Lessee-User. So, even though Lessee-User did not
borrow the money itself, the creditworthiness of Lessee-User is what induced
Bank to loan such a large amount, on such a leveraged transaction, to Lessor-SPE.

Now that Lessor-SPE owns the building, it is leased to Lessee-User under the following
terms.

**Lease Terms**
- Lease payments are $10,000 per year for five years. The lease payments are
  established to be just enough to pay for interest on the loan (10%) and for a
  minimal 10% return on the equity investment of Private Investor.
- At the end of five years, Lessee-User has the option of purchasing the building for
  $100,000. If Lessee-User does not exercise this option, the building is sold, and
  Lessee-User guarantees a residual value of at least $83,800 to Lessor-SPE.

To see how carefully this deal has been constructed to comply with provisions in the
accounting standards, consider the following items.

**Compliance with the Accounting Rules**
The lease terms have been carefully designed to avoid satisfying any of the four capital
lease criteria:

a. There is no ownership transfer to Lessee-User at the end of the 5-year lease term.
b. There is no bargain purchase option. Lessee-User does have the option to purchase
   the building at the end of the lease term, but at an amount equal to the fair value on
   the lease-signing date. This is not considered a bargain purchase option.
c. The lease term (five years) is much less than 75% of the building’s useful life (30
   years).
d. The present value of the minimum payments is less than 90% of the $100,000 fair
   value of the building … barely. In fact, in most synthetic lease arrangements, the
   most careful calculation involves setting the guaranteed residual amount. The present
   value of the minimum lease payments (including the $83,800 guaranteed residual) is
   computed as follows: \( PMT = 10,000, N = 5, I = 10\%, FV = 83,800 \rightarrow \frac{10,000}{1.01^5-1} \times 0.10 + 83,800 \approx 89,941 \).

In addition, according to *EITF No. 90-15*, the minimum outside capital required for a
Lessor-SPE to qualify as an entity independent of the Lessee-User is 3%. Because Private
Investor put up $3,000, this accounting requirement is satisfied.

Under this synthetic lease agreement, Lessee-User has obtained use of the building and has
secured financing for the building but has not been required to report either the building or the
financing on its balance sheet. Consider the questions accompanying this boxed item to determine
whether you think this accounting treatment is honest or deceptive.

**POSTSCRIPT:** With all of the unfavorable attention centered on SPEs and synthetic
leases, the FASB decided to focus on SPEs in its ongoing consolidation project. By some
time in 2002, the FASB hopes to have new rules in place that would result in most debt
associated with SPE and synthetic lease arrangements being reported on the balance sheet
of the sponsoring company.
QUESTIONS:
1. Who benefits if the value of the building increases to $200,000 by the end of the 5-year lease term?
2. Who loses if the value of the building decreases to $10,000 by the end of the 5-year lease term?
3. Under what circumstances would Private Investor earn more than a 10% return on his or her $3,000 investment?
4. Economically, who owns the building? Do you think that synthetic lease accounting, properly applied, is deceptive?
5. Now assume that Private Investor is the chief financial officer (CFO) of Lessee-User. Does this change your opinion of whether synthetic lease accounting in this case is deceptive?

SOURCES:

A GROWING TREND TOWARD SALE-LEASEBACKS
In the early 1970s, sale-leaseback transactions were popular because inflation was causing prices on real estate to skyrocket. Owners of real estate could realize the cash associated with those increasing prices and retain the use of the real estate through leasing.

The volume of sale-leaseback transactions increased in the late 1990s—not necessarily because of inflation but because of businesses’ focus on core business assets. Consider, for example, the case of READER’S DIGEST. The company produces magazines and books, yet in 1999, more than 18% of the company’s reported assets were invested in property, plant, and equipment. The company elected to sell its company headquarters and use the $100 million proceeds to develop new content and distribution channels. The company’s percentage of assets invested in PP&E dropped to 8.7%. Management then proceeded to lease the headquarters complex back.

As expected, Reader’s Digest carefully structured the lease so that it would qualify as an operating lease, with total future minimum lease payments increasing from $68 million at the end of 1998 to $151 million at the end of 1999. None of this obligation is reflected on the liability side of Reader’s Digest’s balance sheet.

QUESTIONS:
1. Identify several advantages to a company of a sale-leaseback transaction.
2. What risks might the company face by entering into this type of transaction?

SOURCE: