Accounting implications for lease classification in acquiring transportation assets

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Abstract

This article investigates the Accounting Standards on lease classification. Global financial tsunami makes bank borrowing difficult. When the US cut interest rate to near zero at Dec 16, 2008, the banks simply refused to respond to rate cuts. To raise funds, transportation companies shift the fund raising options from bank borrowing to equity financing. To attract public investors, companies make promise in the prospectus of not taking risky actions – translate in accounting terms – to maintain a healthy debt-equity ratio.

To bypass such promise, management buys assets and creatively classifies the transaction as a lease rather than a purchase. With such classification, management can engage in risky asset investment behavior regardless on the promise made in the prospectus.

This article studies the current standards set by the IASB (International Accounting Standards Board) and AASB (Australian Accounting Standard Board) on lease classification. In Australia, before 1983, accounting standards were prepared by the accounting profession and had no legislative backing. Since 1983, the Corporation Law has compulsory required Australian public companies to comply with approved accounting standard. Therefore, a violation of the accounting standards represents a non-compliance of the Corporation Law. The legal consequence makes lease misclassification an important topic for transportation companies.

Key words: Lease classification, accounting standards, IASB, AASB

1. Introduction

It is expected that transportation companies, such as airlines and ocean carriers, become difficult to borrow money from banks under the impacts of financial tsunami starting at the end of 2008. When the US cut interest rate to near zero at Dec 16, 2008, the banks simply non-respond to the rate cuts. To raise funds, transportation companies have to shift their fund raising options from bank borrowing to equity financing. To attract public investors, transportation companies need to make promise in the prospectus of not taking risky actions – translate in accounting terms – to maintain a healthy debt-equity ratio.

Purchase of a transportation asset, such as an airplane by an airline or a container vessel by an ocean carrier, would create a huge financial impact on a transportation company's debt-equity ratio. In order to keep the debt-equity ratio unchanged, transportation companies use long term leases rather than the traditional debt financing to acquire the assets. In other words, to the detriment of the public investors, management bypasses the debt-equity promise they made, buys assets and creatively classifies the transaction as a lease rather than a purchase. With such classification, management can engage in risky asset acquiring behavior in contrary to the promise made in the prospectus.

To counter with such misclassification accounting practice, the International Accountant Standard Board (IASB) issues the *IAS 17 Leases* to guide the accounting professionals. The analysis of *IAS 17 Leases* is beneficial because it has taken the task of designing a set of global accounting standards.[1]

When the acquisition of an asset is accomplished by a long term lease rather than through debt financing, it would create at least the following four aspects of differences:

1.1. Difference in financial accounting consequences
1.2. Difference in legal rights of the parties under commercial law
1.3. Difference in income tax consequences
1.4. Difference in legal obligations of the parties under bankruptcy law

In this article, the author will focus only on the difference in financial accounting consequences. This article studies the current standards set by the IASB and AASB (Australian Accounting Standard Board) on lease classification. The study of the Australian accounting standards is helpful to Hong Kong because both Australia and HK share the common foundation in building their accounting standards – both were once British colonies, and adopted the UK accounting standards from the very beginning. In term of subsequent developments, both Australia and HK have decided to harmonize their accounting standards with that of the IAS standards in the same year of 2005. Therefore, the development of Australian accounting standards provides a good reference to HK.

In Australia, the Corporation Law has compulsory required Australian public companies to comply with approved accounting standard. Therefore, a violation of the accounting standards represents a non-compliance of the Corporation Law. The legal consequence makes lease misclassification an important topic for transportation companies.

2. Incentives to Misclassify Leases

The simple term "lease" could cover different types of contracts. Since there exists a multitude of definitions in local GAAP and fiscal legislations, the author adopts the definition used in *IAS 17*, the international accounting standard for leases, where a lease is defined as an agreement whereby the lessor conveys to the lessee, in return for payment, the right to use an asset for an agreed period of time.

The classification of lease arrangement determines the accounting treatment of the transaction. The following table summaries the different treatments[2]:

	Finance Lease	Operating Lease
Asset	- Lessee records the leased item as asset at the inception of the lease - Lessee then reduces the asset amount by depreciation	Nil

[1] IASB's membership was representative of accounting standards boards, rather than of professional accounting bodies, across national borders; therefore, it is in the best position to undertake the task of drafting a set of global accounting standards.
[2] *IAS 17* specifies that "At the commencement of the lease term, the lessee shall recognize the finance lease as an asset and a liability in its balance sheet. The reported amount shall equal to the fair value of the leased item or, if lower, the present value of the minimum lease payments. The reported amount shall be determined at the inception of the lease. The discount rate used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease. The lessee can add any initial direct costs to the recognized asset amount." Australian equivalent can be found on AASB 117-20.

Liability	- Lessee records the entire rental payments as a liability at the inception of the lease - Lessee then reduces the liability through each rental payments	Nil
Expense	- Lessee records only the depreciation expense, not the rental payment as expense	Lessee treats rental payments as expenses

The rationale of recognizing both the asset and liability for the leased item in a finance lease is that if such transaction is not reflected in the lessee's balance sheet, the economic resources and the level of obligations of lessee's company will be understated, thereby distorting the financial ratios. Therefore, the solution of rectifying such understatement is by recognizing in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments.

The financial consequences of the different treatments may create a strong incentive for managers to classify a lease as operating lease rather than as a finance lease. Finance lease classification may create the following adverse impacts on a lessee's financial statements:

2.1. By recognizing the asset at the inception of the lease, it increases the amount reported in the non-current assets, and reduces the return on assets ratio.

2.2. By recognizing the present value of the entire future lease payments as a liability, it increases the amount reported in the non-current liabilities. This will in turn adversely affects the debt-equity ratios and liquidity-solvency ratios.

2.3. By recognizing the entire future lease payments as a liability, this may result in breaching the debt covenants, causing debts to become due immediately.

2.4. The subsequent depreciation and interest expenses may exceed the rental payments, this may reduce the reported profits.

2.5. Depreciation and interest expenses are not deductible for tax purposes.

To check with the incentives to misclassify leases, US issued the SFAS No. 13.[3] However, it fails to remove the underlying incentives of lease misclassification. For example, the US historically allows special purpose entities (SPE), such as Enron, to finance synthetic lease with 97% debt and 3% equity. The rule also allows a lessee to avoid consolidating the SPE if the 3% equity financing is provided by an outside entity unrelated to the lessee or lessor. Enron abused the 3% rule to avoid consolidating many of its SPE, and as a result, about $16 billion of debt was not shown on its balance sheet and hidden from investors.[4]

Drafters of accounting standards and academics have long debated about the complexity of the accounting treatments toward lease contracts.[5] For example, in Canada, when calculating minimum

[3] 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)

[4] Batson, N.: 2003, Second Interim Report of Neal Batson, United States Bankruptcy Court, Southern District of New York, Case No. 01-16034 (AJG), Chapter 11, pp. 9–12.

[5] McGregor, W 1996, *Accounting for leases: a new approach – recognition by lesses of assets and liabilities arising under lease contracts*, FASB, July. The IASB and the US Financial Accounting Standards Board (FASB) published the Summary Report of the Leases Working Group Meeting on February 15, 2007 to recognize the difficulty in defining the operating and finance leases, and its negative impact of reporting economically similar transactions differently. http://www.fasb.org/board_meeting_minutes/10-07-08_leases.pdf

lease payments, all executory costs are excluded; while *IAS 17* only excludes service charges, taxes and reimbursements of expenses paid by the lessor on behalf of the lessee when calculating minimum lease payments. The US experience has shown that neither the Accounting Research Committee of the AICPA nor the Accounting Principles Board was able to build a consensus with this issue. FASB saw the subject of accounting for leases as one of its first priorities; nevertheless, despite multiple revisions including nine FASB amendments, six FASB Interpretations, 12 FASB Technical Bulletins, there is universal agreement that SFAS No. 13 fails to achieve its stated objectives.

3. Scope of Application - IAS 17 Leases

IAS 17 does not apply to licensing agreements, such as patents and copyrights.[6] Therefore, *IAS 17* applies to the tangible asset of an airplane, but it does not apply to the ultrasonic scanning systems used in structural flaws inspection of airplane parts during the repair stage.

Besides, *IAS 17* does not apply to service contracts.[7] In other words, when airplane manufacturer leases an airplane to an airline company, with an obligation to provide maintenance service; *IAS 17* does not apply to the service portion of the lease because it does not transfer the right to use the airplane.

4. When to Make the Classification?

IAS 17 specifies that lease classification should be made at the inception of the lease.[8] Lease renewal is not subjecting to the process of classification. If at any time the lessee and the lessor agree to change the provisions of the lease in a manner that would have resulted in a different classification, the revised agreement is regarded as a new agreement over its term, and such revised agreement is subject to classification.

However, changes in estimates (for example, changes in estimates of the economic life of the leased property) do not give rise to a new classification of a lease.

5. Economic Life under *IAS 17*

IAS 17 defines economic life in two ways: (1) it refers to the economically usable period of an asset; or (2) it refers to the number of production units expected to be obtained from the asset.[9]

Economic life is one of the important elements for classifying a lease under *IAS 17*. Since *IAS* 17 uses the risk and reward factors as the criteria to classify a lease, and risks and rewards are closely connected with an asset's economic life. *IAS* 17 defines risks as the possibilities of losses from idle capacity or technological obsolescence because of changing economic conditions.[10] Rewards are defined as the expectation of profitable operation over the asset's economic life.[11]

Since finance lease gives rise to depreciation expense for each reporting period through out the economic life of the leased item. The calculation of depreciation expense is particularly relevant for airliners because aircraft components have different economic life in tax law. The mechanical structure of an aircraft has a longer useful life expectancy up to say 25-years. Aircraft engines, on the other hand, have a shorter economic life, about 10-years. For landing gear, it normally has only 7-years of estimated useful-life expectancy.

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[6] Australian equivalent can be found on AASB 117-2(b).
[7] Australian equivalent can be found on AASB 117-3.
[8] Australian equivalent can be found on AASB 117- 13.
[9] Australian equivalent can be found on AASB 117- 4.
[10] Australian equivalent can be found on AASB 117- 7.
[11] Ibid.

IAS 17 reminds accounting practitioners not to make judgment solely based on the legal form of a lease; in other words, economic life analysis provide a better alternative in judging the financial substance of a leasing arrangement. For example, a lawyer may conclude an arrangement is a lease and not a purchase because the lessee does not acquire legal title to the asset; an accountant will focus on the facts that if the lessee acquires the economic benefits of an asset for the major part of its economic life, the accountant should classify the arrangement as a purchase, in other words, a finance lease.

6. Guiding Principles of Classification - Finance Lease under *IAS 17*

Under *IAS* 17, a finance lease transfers substantially all the risks and rewards of an asset incidental to ownership.[12] Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.[13] *IAS* 17 illustrates with following five examples that would "normally" be classified as finance lease:

6.1. If a lease transfers ownership of the asset to the lessee by the end of the lease term, it is likely to be a finance lease.[14]

6.2. If a lessee contains an option to purchase the asset at a price that is sufficiently lower than the fair value, it is likely to be a finance lease. *IAS* 17 defines fair value as the amount for which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction.[15] (Checking the existence of an option is rather straight forward, because it can be ascertain within the four corners of the lease contract, however, the difficulty for an accountant is to make a professional judgment on whether at the inception of the lease, the lessee would likely to exercise that the option in the future.)

6.3. If a lease period covers the major part of the economic life of the asset, even the title is not transferred, it is likely to be a finance lease. *IAS* 17 defines lease period as the non-cancellable period, which includes the option to continue the lease.[16] (The difficulty for an accountant is to make a professional judgment on whether at the inception of the lease, the lessee would likely to exercise that the option in the future.) If the lease period is 12 years, and the economic life of an airplane is 20-years, it covers only 60% of the economic life and hardly be classified as a finance lease. However, if majority of the benefits is received within the first 12 years, the accountant has to make a professional judgment on whether it constitutes "major part of the asset's economic life".

6.4. If the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset, it is likely to be a finance lease. The calculation of the minimum lease payments is discounted to the inception of the lease.

6.5. If the leased assets are of a specialized nature that only the lessee can use them without major modifications, it is likely to be a finance lease.

7. Judgmental Nature of Lease Classification under *IAS 17*

Lease classification is essentially an exercise of professional judgment. The readers of *IAS 17* must bear in mind that the five examples shall not be seen as a definitive list of all situations that an accountant should consider; there may be other situations that give rise to a lease being classified as a

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[12] Australian equivalent can be found on AASB 117- 8.
[13] Australian equivalent can be found on AASB 117- 10.
[14] In AASB 117- 4, it specifies that even title is not eventually transferred, so long as the lease transfers substantially all the risks and rewards, it still can be classified as a finance lease.
[15] Australian equivalent can be found on AASB 117- 4.
[16] Ibid.

finance lease that are not listed. *IAS 17* intentionally uses the word "normally" to remind the readers the existence of other possible exceptions.

8. Likelihood to identify Lease Misclassification

Lease misclassification is a type of fraudulent financial reporting; because by deliberately classifying a lease as operating lease, a company can understate its debt and make its reported profit looks better than it should be. Fraudulent financial reporting is a matter of grave social and economic concern (Kaminski, 2004). For auditors, a failure to detect false financial statements would cause legal liability and severe negative impacts to professional reputation, for instance, the failure to detect Enron's accounting fraud eventually led to the collapse of Arthur Andersen.[17]

Analytical procedures (APs)[18] have been recognized as a useful tool for detecting accounting fraud (Thornhill, 1995). APs involve the procedures of analyzing trends, ratios, and reasonableness tests derived from an entity's financial data (Albrecht, 2004). In the US, an auditor must perform APs in audit planning with an objective to identify the unusual events, amounts, ratios and trends (AICPA, 1988). However, accounting academics found that only 4 out of 24 fraud cases could be detected by APs (Blocher,1992). Therefore, without the exercise of ethnical sense and good judgment from the financial statements preparers, the likelihood to identify lease misclassification by external auditors may not be high.

Lease classification would involve a significant degree of second-guessing; and many preparers, instead of exercise their professional judgment, would rather choose to play the safe game by urging the accounting bodies to issue more bright lines rules, so that they could get ready answers to solve the detailed fact patterns they face. However, too much bright lines rules would eventually lead to a rules-based approach, which in turn adding complexity to the financial reporting system. Say Robert Herz, the FASB Chairman, that the U.S. system has too many rules and bright lines, too much detail; and they undermine professionalism, both in the preparation of financial statements and in auditing. (Kranacher, 2007)

In fact, in its July 2003 report to the US Congress, the US Stock Exchange Commission (SEC) urged the adoption of a principles-based accounting standards system. Under the ideal system, the FASB should only articulate the broader principles, then explain them, where possible, with real-world examples. The FASB should not get into every possible fact pattern or create unnecessary exceptions, in other words, FASB should try its best to stay away from creating bright lines (Kranacher, 2007).

9. Training on Professional Judgment

The final issue this article will address is the training of professional judgment. In lease classification, the preparer of financial statements has to determine at the inception stage, whether a lease arrangement be classified as finance or operating, this calls for the exercise of professional judgment. The issue here is whether we can bring students to the expert level though university training.

Even in the very ideal scenario, it will take about 10 years of sustained practice for a practitioner to reach expert level performance in professional judgment of his field (Ericsson, 1996). The ideal learning environment would be one that allows a great deal of relatively quick and clear feedback. In hospitals (and in medical school), there is usually an outcome where the patient gets better or worse in response to a treatment, so the medical student can get feedback and learn from it. However, accounting practice is not a field that could generate quick and clear outcome feedback. In accounting,

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[17] Before the Enron accounting fiasco, Arthur Andersen reached a high of 28,000 employees in the US and 85,000 worldwide; after the Enron instance, the firm has downsized to only 200 employees, based primarily in Chicago, and most of their attention is on handling the lawsuits and for the orderly dissolution of the company.
[18] APs refer to the variety of techniques an auditor use to assess the risk of material misstatements in financial records.

we have to rely on a delayed review process to get feedback. Recent research indicates that auditors have very poor understanding of the technical knowledge of other auditors (Kennedy and Peecher, 1997; Tan and Jamal, 2006). Therefore, says professor Karim Jamal from University of Alberta, that as educators, we cannot bring our students to the expert level; we should get them ready to move out into a world of practice where they will reach peak performance some years later. However, we can't leave it all up to accounting practice, because of the comparatively weak learning environment that it provides. Professor Jamal did a research on reviewers' biases in accounting field and found that there existed numerous biases in reviewers' evaluation of their subordinates' work (Tan and Jamal, 2001).

10. Conclusion

This article investigates the accounting implications for lease classification, with a particular focus on IASB and AASB treatments on lease classification. When a manager structures a contract for leased asset in a manner that the company can enjoy benefits similar to outright ownership, but in a way to keep both the leased asset and related liabilities off the company's financial records, the unethical motives for lease misclassification contribute to many of the accounting debacles. [19]

To check with the lease misclassification, *IAS* 17 outlines a judgmental framework for accounting practitioners for decision making. The author submits that an Australian company that makes lease classification which complies with the Australian standards outlined in AASB 117 will substantially be in compliance with that standards issued by the International Accounting Standards Board. A reading of the *IAS* 17 shows that 20 percent of its paragraphs were devoted to the classification of finance lease, which aims not at creating a bright line lease classification rule for the accounting practitioners. The author further submits that the quality of professional judgment and the ethical behavior will serve the public much better, so as to faithfully perform the accountants' stewardship responsibility, than a technical expertise to just merely meeting a bright line rule for financial reporting.

In terms of training for professional judgment, the author submits that accounting academics need to do a better job in school because the actual accounting practice environment is negatively affected by delayed review process and biased reviewers, a poorer learning environment for developing professional judgment.

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[19] Thomas J Frecka, *Ethical Issues in Financial Reporting: Is Intentional Structuring of Lease Contracts to Avoid Capitalization Unethical?* Journal of Business Ethics, Dordrecht: Jun 2008, Vol. 80, Iss. 1; p. 45 (15 pages)

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