

LEASES: AN ACCOUNTING VIEW

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While I expect today to talk primarily about leases from an accounting point of view, I think it is appropriate that I begin with a few remarks about leases as a financing device. Basically, I believe that lease financing is a good thing. It has proven to be a creative and flexible financing vehicle which can respond to specific financing and tax needs of companies of many different sizes and forms. This is, in fact, an excellent example of what the private sector can do in the financing area to respond to particular needs. We are hopeful that the Wall Street community, freed from the shackles of fixed commissions, will be able to develop more creative vehicles of this sort.

It is apparent to me that leasing does not need to be justified on the grounds that the accountants' unwillingness to cope with it makes it possible to use this vehicle to present a misleading financial statement. The leasing community's historical emphasis on the off-balance-sheet nature of this financing is neither good for the leasing business nor for the credibility of the business community. If lease financing is sold on the grounds that you don't have to "tell it like it is," the impression is left that leasing itself is somehow devious. In addition, if lease financing is sold primarily on this basis, you may be so successful in persuading customers of this "advantage" that your business runs the risk of being unduly damaged economically when accountants finally catch up with economic reality--and they will do so. Thus, it seems to me that there is no good reason for the leasing community to be leading the fight against good accounting for lease transactions.

Let me turn to the subject of lease accounting. At the present time I believe that lease accounting constitutes a clear and apparent abuse. I am sure that I am not breaking any news to you when I say that lease accounting is one of the most spectacular sources of the accountants' lack of credibility that exists today.

Ironically the spirit of the literature on the subject is not so bad. Whenever I address an audience in my missionary capacity I like to quote the gospel and, accordingly, let me read to you a section from Accounting Principles Board Opinion No. 5 which constitutes the writing on the tablets of this area. This opinion states that "some lease agreements are essentially

equivalent to installment purchases of property. In such cases the substance of the arrangement rather than its legal form should determine the accounting treatment. The property and the related obligations should be included on the balance sheet as an asset and a liability, respectively, at the discounted amount of the future lease rental payments, exclusive of payments to cover taxes and operating expenses other than depreciation.”

As all of you are aware, however, this fine opinion had within it the seeds of its own destruction in the “material equity” loophole through which an incredible number of installment purchases in lease form have passed. It appears that at the time the APB wrote this opinion there were some members who felt they had a strong statement, while others were already calculating the ways in which its spirit could be avoided.

Lease accounting, therefore, has become an example of “least common denominator accounting” at its worst. The financial community drove an all-to-willing accounting profession down the primrose path strewn with false analogies. While the profession and the SEC have attempted to shore up a crumbling structure with disclosure rules, this is clearly not a sufficient long-term answer. Disclosure in reality emphasizes the inadequacy of basic financial statements and demonstrates that form is triumphing over substance. We have long said that you cannot mend basic misstatements in the face of the financial statements with footnotes. Yet, this is what we have been trying to do.

Let me give it to you straight, therefore. Lease accounting is going to change and soon. The Financial Accounting Standards Board is currently studying the subject with hearings scheduled in two weeks. The Commission supports the Board and believes that it is well equipped to deal with accounting problems. Its progress is significant to date. We work well with the FASB and are in frequent communication with them. My staff attends meetings of FASB task forces and I attend meetings of the Financial Accounting Standards Advisory Council as an invited guest. We request and receive copies of letters of comments which they receive on issues. While we do not feel it is appropriate for us to make formal inputs to their decision-

making process, we talk frequently with them and they are aware of our concerns and we of theirs.

At the same time the Commission has a statutory responsibility and authority in this area. In circumstances where we perceive a dominant investor interest it is obviously essential that effective communication of this view take place.

Lease accounting is one area in which we perceive such a dominant investor interest. Current accounting practices must be changed. A continuation of the status quo is unacceptable. I believe that at a minimum the Financial Accounting Standards Board will conclude that capitalization of leases which are primarily financing devices to permit the acquisition of assets will be required. The assets and financing must be accounted for as such on the balance sheet and in the income statement. In addition, I believe that such accounting must be applied to present as well as to subsequent leases. It is not acceptable to leave current financing off balance sheet while treating subsequent leases differently. The lack of comparability that would exist as the result would be affirmatively misleading to investors.

If economic detriment actually is felt by companies which would be required to capitalize leases, we believe that it can only be based on a prior misconception on the part of users caused by insufficient disclosure so that substance was not perceived, or by transitional problems. It is apparent that we cannot be satisfied with insufficient disclosure which produces a misleading result if we are to faithfully administer the Securities Act. Transitional problems must be dealt with as such; they cannot justify inaction.

It is my judgment, therefore, that the FASB will move in the direction of lease capitalization with the enthusiastic support of the Commission and the accounting profession. The case seems to be a clear one. If the Board were to take no action to require lease capitalization, we would have to consider what action we should take, but I do not anticipate this happening. I believe that the Board and the accounting profession will agree that lease capitalization is necessary for a fair presentation of financial position and results. Indeed, the

Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has already taken such a position.

I should emphasize that we do not intend to tell the FASB what to do in the leasing area. There are many issues which must be settled. In the first place, there are major problems of definition which must be solved. The Board must conclude whether or no leases should be dealt with solely as one class of executory contract or whether they should be considered separately. There must also be consideration as to whether or not any capitalization techniques employed should relate to all leases or only to certain leases perceived as de facto purchases of equipment. It would be possible, for example, for the Board to conclude that all leases should be capitalized either on theoretical grounds based on articulated measurement principles relating to the definition of assets and liabilities or on practical grounds resulting from the difficulty of distinguishing the dividing line between financing and operating leases. In addition, there are problems as to how the interest component in leases should be treated.

My own personal preference runs in the direction of capitalizing leases which are in substance purchases. Since a lease is a highly flexible transaction form, we do not expect "perfect" criteria to be established. Greatly improved criteria can be enunciated, however, and followed in practice. Accounting Series Release 147 is an example. It is apparent that the legal form of a transaction cannot be controlling in this regard.

We and the FASB are already beginning to receive evidences of a campaign to involve Congress in this issue. The essence of many of these appeals are based on the things which tug at Congressional heartstrings: higher prices to consumers, hardship to small business, and less availability of capital. We do not believe that a rational case can be made that changes in lease accounting will have a significant effect on such matters. Lease disclosure is already such that data are available to the suppliers of capital. Moving leases on to a balance sheet should not have that great an impact.

Higher prices are a function of higher costs, not accounting principles. Regulatory commissions with rate-making authority are qualified to appraise economic phenomena and the

market place is certainly capable of digesting and using economic information in a rational fashion.

I believe that this Congressional campaign is certainly a disservice to the concept of setting accounting principles in the private sector. A successful campaign might bring down the FASB but I doubt that it will avoid lease capitalization.

The Commission staff is certainly prepared to work with the FASB in the process of communicating the realities of the lease accounting issue to Congress and the Congressional staffs. We believe that the issue can be appropriately explained in that forum and that what appear to be major fears of Congressmen in the area can be allayed.

I have emphasized the lessee side of lease accounting today because that is where most of the accounting problems lie. Let me now say a few words about the lessor side of the coin. Basically, it is my judgment that lessor accounting is pretty good today based upon APB Opinions 7 and 29. Some significant problems exist in the leveraged lease area which we believe the FASB will be able to deal with.

In today's environment, however, the greatest accounting problems with respect to lessors probably relate to the quality of lease portfolios and reserves. These are not problems of accounting theory but empirical estimation. In any economy which is on the downgrade there will inevitably be credit problems which arise. Under such conditions it seems likely that more disclosure of the nature and quality of a lease portfolio may be required. Perhaps there should be comparative disclosure of delinquencies and other credit danger signals.

It is apparent that the accounting model which requires the accountant to come to a single figure for reserves cannot fully communicate changing patterns of uncertainty. I believe that uncertainties must be better communicated in this and in other areas. I hope that the accounting profession will take steps in this regard.

In summary then, better accounting for leases is needed and will come. It will come soon. Nevertheless, it is my judgment that leasing and lessors will continue to flourish, perhaps

with even enhanced prosperity, because they serve an important need in our capital markets and these markets will continue to reward those who meet economic needs.

