Synthetic Leases; Uses, Abuses and the Future

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ABSTRACT

A large portion of currently reported leases relate to real estate and equipment that is estimated to be a $200 billion-a-year industry. Among public companies, an estimated 90 percent of the leases are not reported on the company's balance sheet. One method of lease capitalization circumvention is the synthetic lease. The synthetic lease permits a company to achieve off-balance sheet financing by reporting a rent obligation operating lease rather than an asset encumbered by a mortgage. At the same time, the company reports for federal income tax purposes that it owns an encumbered assets used in its trade or business, thus entitling it to recognize depreciation deductions. In a typical synthetic lease transaction, the parties agree that the tenant, not the landlord, will consistently report an investment in a depreciable asset for tax purposes. This means that the synthetic lease is a type of off-balance-sheet financing that allows a company to obtain the benefits of property ownership without a negative impact on its financial ratios.

The net unrecorded lease liability equals just over 89 percent of the total reported liabilities while the unrecorded leased assets are over 39 percent of the total reported assets. The average impact of the lease capitalization on the retained earnings is a reduction of about 47.6 percent of the average reported retained earnings. Had the leases been structured as synthetic leases to take advantage of the capital lease tax benefits, the mean cumulative tax benefits would amount to some $674.6 million (and thus, an increase of cash flows) or 25.3 percent of the reported retained earnings.

Both FASB and the IASB are considering changes to the recognition and accounting for leases as they attempt to converge accounting for lease guidance. As of July 2008, the Boards have tentatively agreed to apply the present finance lease model to all leases which would result in all leases being capitalized.

Unraveling synthetic leases by reporting the leased assets and respective liabilities on the balance sheet could disrupt equity markets and force companies to take on large sums of debt which would ultimately depress their earnings. However if all leases were capitalized on the balance sheet, it would bring lease accounting in conformity with existing tax laws. Although there are many instances where tax and financial accounting treatments diverge, this total capitalization approach should reduce, if not eliminate, the asymmetry in lease accounting, as well as minimize its abuse and capitalization circumvention. Lease capitalization will result in a more conservative balance sheet and give a more accurate measure of a company's liquidity and profitability ratios.

References furnished upon request.