Accounting for leasehold property in the UK: A triumph of substance over form?

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ABSTRACT

This paper is concerned with accounting for leasehold property. While property professionals are familiar with commercial and technical aspects of leases, recent proposals offer serious implications beyond the notional historical reporting of an entity's financial position. Current proposals issued by the ASB will markedly impact upon the financial position reported by businesses holding leasehold properties, with consequent effects upon their reported profitability and their ability to raise finance. This paper examines the current position, whereby leases are regarded as either a finance or an operating lease. It then examines the conceptual framework in which accountants view the existing lease reporting provisions, examining the unease the current provisions cause. Finally, it discusses the most recent proposals and offers a commentary upon responses to them. It concludes with a warning to the owners and users of leasehold property to be ready for change — or to make their voices known.

Keywords: accounting standard, consultation, lease, leasehold, property

INTRODUCTION

The subject of leases has recently been discussed within two technical and commercial contexts within the property profession. First, the concept of the lease length has been discussed with a view to replacing the traditional 25-year lease by shorter and more flexible alternatives. This is seen as a response to the commercial needs of users willing to reimburse property owners with higher payments for this flexibility. It was mooted by the 'Right Space: Right Price?' Reports for the Royal Institution of Chartered Surveyors[4] and variously discussed in different forums along different commercial angles.[5] Secondly, and more recently, has been fought the popularly titled 'Great Rent Review Debate' concerning the possibility of

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either regulation or code of practice for the upward-only rent review.[5]

There is, however, a third subject that has recently been revisited concerning the lease, and that is the manner in which it should be accounted for. The following paper aims to examine the existing situation as a means of explaining both current practice and the rationale for proposed revisions to the existing approach. A future paper will examine the responses received by the Accounting Standards Board (ASB) as part of the formal process of creating a new standard, and the new standard itself.[7] In 'Accounting for Property in the UK: The Legal and Professional Framework'[8] the authors outlined the main issues surrounding the valuation and reporting of owner-occupied property and tangible fixed assets in UK financial reports. The present paper builds on this and focuses on the different accounting requirements when valuing and reporting leasehold property and other leasehold tangible fixed assets.

LEASE ACCOUNTING: POLITICS AND PROBLEMS

Historically, UK leasehold accounting has been a highly sensitive and political issue, with different views and concerns expressed by the accounting profession, the legal profession, property companies and valuers. This is particularly evinced within the arguments that revolve around concerns expressed about the 'economic consequences' of accounting standards for corporate performance. Furthermore, the complex nature of leasehold contracts, along with observed abuses and creativity in lease accounting practice, has led to immense concern about just how to establish the accounting 'substance' of such contracts. For the lawyer, it is the legal form of the lease contract that matters. For the leaseholder, it is the commercial nature of the lease that holds interest. However, in order to give valuable information, the accountant seeks to unravel the substance of the transaction of the form, and by doing so attempts to report in the accounts the actual financial implications of the lease. This is not always easy to achieve under the current accounting rules.

PRESENT ACCOUNTING RULES: SSAP 21

The accounting rules[9] governing lease accounting are contained within Standard Statement of Accounting Practice (SSAP) 21, 'Accounting for Leases and Hire Purchase Contracts', which was issued in 1984. In the accounts of a lessee, the correct accounting treatment to adopt directly hinges on the application of a rule that first attempts to establish whether or not all the risks and rewards of owning a leased property are transferred to the lessee. If the risks are transferred to the lessee, the lease is recorded as a *finance lease*, and the lessee has to record both an asset and a liability in respect of the payments the lease requires. In essence, this is basically akin to the situation where the lessee itself actually purchased the asset outright in cash. If the risks and rewards of ownership are not transferred to the lessee, the lease is classified as an *operating lease*, and the only accounting needed by the lessee is to include a note about the operating lease commitments in the accounts. Thus the most important definitions of SSAP 21 are as follows.

A *finance lease* is a lease which transfers substantially all the risks and rewards of ownership of an asset to the lessee. It should be presumed that such a transfer of risks and rewards occurs if at the inception of a lease the present value of the minimum lease payments (MLP), including any initial payment, amounts to substan-

Table 1: Determining a finance lease

Process	*Comment*
(1) Calculate the total MLP inclusive of initial payment	MLP = minimum lease payments *plus* any residual amounts guaranteed by lessee
(2) Determine the present value (PV) of the total MLP	Discount factor to use is either: (a) Rate of interest implicit in lease; or (b) A commercial rate of interest
(3) Calculate the 'fair value' of the asset at beginning of lease	'Fair value' = the arm's length price *less* any government grants receivable by lessor
(4) It is a finance lease if (2) amounts to 90% or more of (3)	This is the 'rule of 90%'

tially all (normally 90 per cent or more) of the fair value of the leased asset.

An *operating lease* is a lease other than a finance lease. An operating lease has the character of a rental agreement, with the lessor usually being responsible for repairs and maintenance of the asset.

If the lease is an operating lease, the accounting for the lessee is simply to charge the annual rental charge against the profit and loss account for the year. If a lease is determined by the rules of SSAP 21 to be a finance lease, the resulting accounting is much more complicated for the lessee. This will be discussed in more detail below. In the accounts of the lessor, the accounting generally mirrors the treatment of leases followed by lessees, with finance and operating leases being reported differently in the accounts. The accounting disclosures required by lessors are also discussed below, although the emphasis of this paper is on the accounting for lessees.

Identifying a finance lease under SSAP 21: 'The rule of 90 per cent'

The 'rule of 90 per cent' is the most critical aspect of SSAP 21, since it serves to identify what qualifies as a finance lease in the annual accounts. The critical factor is to calculate the minimum lease payments (MLP) that the lessee has guaranteed to pay under the terms of the lease agreement. This calculation is shown in Table 1.

As an example of this rule, consider the following simple lease agreement. A Ltd leases a property from B Ltd on 1 January 2000. £10,000 is payable immediately, followed by three annual payments on 1 January of 2001, 2002 and 2003. The agreed fair value of the property is £34,868 and the interest rate implicit in the lease is 10 per cent per annum. A Ltd has the right to continue using the asset at the end of the three-year lease at no cost. The expected useful life of the property is five years, at which time it will be worthless.

The present value of the minimum lease payments is £10,000 plus the present value of an annuity of £10,000 paid for three years at a discount rate of 10 per cent per annum. In total this comes to £34,868, which equals 100 per cent of the fair value of the leased asset. Thus, according to SSAP 21, this lease is a finance lease.

Finance leases

Initial accounting entries

For a lessee, at the start of the finance lease both an asset and its counterbalancing

Table 2: Allocating finance charge — actuarial method

Period	*Capital sum at start of the period*	*Rental paid*	*Capital sum during the period*	*Finance charge*	*Capital sum at end of the period*
2000	£34,868	£10,000	£24,868	**£2,487**	£27,355
2001	£27,355	£10,000	£17,355	**£1,736**	£19,091
2002	£19,091	£10,000	£9,091	**£909**	£10,000
2003	£10,000	£10,000	—	**—**	—
				£5,132	

liability have to be entered into the accounting records. These entries are equal to the following.

The *asset* is the present value of the MLP and should be included as a fixed asset in the balance sheet. In the A Ltd example, this is £34,868.

The *liability* equals the obligations to pay rentals under the lease. This will equal the present value of the rental payments, which again are £34,868.

Depreciation of the underlying lease asset

The related fixed asset should be depreciated over the shorter of *either* the economic useful life of the asset *or* the term of the lease (which is the period over which the lessee uses the asset). For the A Ltd example, this charge would be £34,868 spread over five years, equating to annual depreciation of £6,974.

Allocation of finance charges

Over the lease term, the total finance charge is the amount by which the rentals paid by the lessee *exceed* the present value of the MLP. From the A Ltd example, this comes to a total charge for finance of £5,132. The total finance charge should be allocated in a fair manner over the term of the lease; this is normally done using the actuarial method. The calculations using this method for the A Ltd example are shown in Table 2.

Thus the total finance charge of £5,132 is allocated during the term of the lease. Each individual rental payment paid is split between paying the finance charge for the period (a profit and loss account item) and repaying future obligations to pay rentals (thus reducing the balance sheet liability).

Accounting disclosures required for lessees: Finance leases

All that remains is to discuss the accounting disclosures required for all types of leases under SSAP 21. For a lessee having a finance lease these are as follows.

Balance sheet: Fixed assets

Show by each major class of asset the gross amounts of assets held under a finance lease and any related accumulated depreciation.

Balance sheet: Liabilities and obligations under finance leases

The amounts of obligations related to finance leases (net of finance charges allocated to future periods) should be disclosed separately from other obligations and liabilities, either on the face of the balance sheet or in the notes to the accounts.

These net obligations under finance leases should then be analysed between amounts payable in the next year, amounts payable in the second to fifth years inclusive from the balance sheet, and the aggregate amounts payable thereafter.

Profit and loss account

The total depreciation charge and aggregate finance charges for the period in respect of finance leases should be disclosed in the profit and loss account for the year.

As an illustration, the disclosures required for the A Ltd example at 31st December, 2000 are set out in Table 3.

Accounting disclosures required for lessees: Operating leases

According to SSAP 21, the accounting disclosures required for operating leases are:

Balance sheet: Obligations under operating leases

In respect of operating leases, the lessee should disclose in a note the payments that it is committed to make during the next year. These payments should be analysed between those for leases in which such commitments expire within that year, in the second to fifth years inclusive, and over five years from the balance sheet date. Commitments in respect of leases of land and buildings and other operating leases should be shown separately.

Profit and loss account

The total of operating lease rentals charged as an expense in the profit and loss account should be disclosed, analysed between amounts payable in respect of hire of plant and machinery and in respect of other operating leases.

Accounting disclosures required for lessors: Finance leases

From the viewpoint of the lessor, SSAP 21 requires the following accounting disclosures in the lessor's accounts.

Balance sheet

The amount due from the lessee under a finance lease should be recorded in the balance sheet as a debtor at the amount of the net investment in the lease after making provisions for items such as bad and doubtful debts. From the earlier example, for B Ltd this would have been £34,868.

Profit and loss account

The total gross earnings under a finance lease should normally be allocated to accounting periods to give a constant periodic rate of return to the lessor's net cash investment in the lease in each period.[10]

Accounting disclosures required for lessors: Operating leases

Balance sheet

The property or asset leased should be included as a tangible fixed asset. It should be depreciated according to its estimated useful economic life.

Profit and loss account

Rental income should be allocated using a straight-line method of allocation. Any depreciation on the asset should be charged as an expense.

Disclosure of Accounting Policies

One further disclosure is required for both lessees and lessors: namely, the accounting policy adopted as regards the treatment of leases in the accounts. This has to be disclosed by way of a note to the accounts.

Table 3: A Ltd disclosures for the finance lease during 2000

	£	£
Balance sheet as at 31st December 2000		
Fixed assets		
Leased property under finance leases:		
Cost	34,868	
Less aggregate depreciation	6,974	
Net:		27,894
Creditors: amounts falling due within one year		
Obligations under finance leases*		8,264
Creditors: amounts falling due after more than one year		
Obligations under finance leases due within two to five years		19,091
*The amount payable in 2001 is £10,000, but that includes a finance charge not yet accrued at 31st December 2000 of £1,736		
Alternatively, the creditors information could be disclosed by a note to the accounts as:		
Obligations under finance leases:		
Due within one year	10,000	
Due within two to five years	20,000	
	30,000	
Less: finance charges allocated to future periods	(2,645)	
	27,355	
Profit and loss account for year ended 31st December 2000		
Interest payable:		
Finance charges in respect of finance leases	2,487	
Depreciation	6,974	

ACCOUNTING PROBLEMS WITH THE SSAP 21 'RULE OF 90 PER CENT'

As might be expected, the 'rule of 90 per cent' contained in SSAP 21 does not always provide conclusive evidence about the correct accounting treatment to adopt. The risks and rewards associated with the ownership of an asset can pass in other situations. A lessee could effectively control a leased asset without paying minimum lease payments that are equal to or exceed 90 per cent of the fair value of the asset. As long as the lessee controls the leased asset, it effectively 'owns' it and should show the associated asset and liability in its accounts. The 'rule of 90 per cent' cut-off was never meant to be applied in a mechanistic way by accountants, but that has tended to be the manner in which it has been applied in the past in an effort to get leases 'off balance sheet'. As will be shown in the next section, in 1994 the ASB introduced another standard, FRS 5, aimed at supplementing the deficiencies apparent in lease accounting under SSAP 21.

Greater lease complexity: The role of FRS 5

Since SSAP 21 was introduced in 1984, the terms of many lease contracts have become increasingly complex, often exhibiting characteristics of both a finance lease and an operating lease. Because of this, SSAP 21 relying exclusively on its 'rule of 90 per cent', has become a relatively blunt instrument for tackling the accounting implications of leases. As was

shown above, the approach of SSAP 21 can be described as 'all or nothing' — that is, a leased asset and related obligation to pay rentals remain wholly off balance sheet until the '90 per cent' threshold is passed. At this point, the full fair value of the asset and an equal liability come onto the balance sheet.

In an effort to improve both lease and other forms of accounting, FRS 5, 'Reporting the Substance of Transactions', was issued by the ASB in 1994. FRS 5 was aimed at giving guidance on how to account for complex transactions (such as leases) where the: 'true commercial effect of such transactions may not be adequately expressed by their legal form'.[11]

FRS 5 applies where an existing standard is being openly flouted by exploiting a technical interpretation of its words to override its 'spirit'. The reasons behind its introduction need to be put in context. The FRS 5 standard arose as the ASB's direct response to creative over-provision of future liabilities, costs and expenditures (dealing with re-organisation costs in this manner was very popular) by companies attempting to smooth out their reported profits. As such, FRS 5 provides a framework that attempts to force companies to report assets and liabilities in their accounts according to the underlying economic 'substance' of the transaction that brought them into being. In essence, for FRS 5, the 'legal form' of a transaction is always secondary to the actual recording of its economic 'substance'. In terms of leasing, the aim of FRS 5 is to force companies to record leases as finance leases if that is their 'true substance'.

Before attention is focused on the actual rules and definitions contained in FRS 5, it is important to ascertain how it operates alongside SSAP 21. FRS 5 gives clear guidance on its relationship with other accounting standards. The general requirement is that whenever a transaction is covered by more than one rule, the most specific should be applied. With SSAP 21, 'Accounting for Leases and Hire Purchase Contracts', the position as to which standard is the most specific is not entirely clear. The key question is whether the requirements of FRS 5 always override those contained within SSAP 21. FRS 5 states that:

> 'In general, SSAP 21 contains the more specific provisions governing accounting for stand-alone leases that fall wholly within its parameters, although the general principles of the FRS [5] will also be relevant in ensuring that leases are classified as finance or operating leases in accordance with their substance.'[12]

Consequently, SSAP 21 remains the relevant accounting standard for dealing with straightforward leases, but FRS 5 is the relevant accounting standard for dealing with complex leases or leases which form part of a series of transactions (most notably where a sale and leaseback arrangement is entered into). According to this quote from FRS 5, it seems that where, for example, the 'rule of 90 per cent' test in SSAP 21 indicates that a lease should be operating, but in 'substance' the lease is clearly finance, then FRS 5 requires SSAP 21 to be overruled. Obviously, this introduces an element of accounting discretion into the treatment of each and every lease held by a company. Accountants must first appeal to SSAP 21 and then check whether FRS 5 can offer any further guidance. In certain situations this can make ascertaining the appropriate accounting treatment to adopt much more difficult.

The approach taken by FRS 5 is entirely different from that adopted in SSAP 21. Under FRS 5, a key step in report-

ing the 'substance' of any transaction is to identify its effect on the assets and liabilities of the entity. Once it appears from analysis of the transaction that either an asset or a liability has been 'acquired' by an entity, it simply remains to be ascertained whether it should be included in the balance sheet. The definition and recognition of assets and liabilities under FRS 5 utilises the same approach as later adopted by the ASB's 'Statement of Principles for Financial Reporting', issued in 1995. According to FRS 5 a liability is 'An entity's unavoidable obligations to transfer economic benefits as a result of past transactions or events'.[13] Assets are defined as 'Rights or other access to future economic benefits controlled by an entity'.[14]

Under FRS 5, an obligation to transfer benefits must be evidenced by the existence of some circumstance by which the entity is unable to avoid, legally or commercially, an outflow of benefits. Thus FRS 5 emphasises the amount of liability that an entity expects to pay, which is the present obligation that the entity *is unable to avoid*. Where a transaction such as a lease includes an option to cancel, FRS 5 requires one to assume that the transaction will be extended when there is no genuine commercial possibility that it will not be, assuming that each party acts in accordance with its economic interests. Thus FRS 5 goes beyond reporting the mere legal form of a transaction and attempts to show the commercial substance and 'risks and rewards' of a transaction. By doing so, it effectively prevents many forms of 'off balance sheet' financing.

FRS 5 states that the liability and asset definitions should be applied to each and every transaction. Should a transaction result in an item that meets either definition, that item should be recognised in the balance sheet if:

(1) there is sufficient evidence of the existence of the item (including, where appropriate, evidence that a future inflow or outflow of benefit will occur); and
(2) the item can be measured at a monetary amount with sufficient reliability.

In this way FRS 5 is aimed at capturing the 'substance' over the mere 'legal' form of transactions such as leases. By doing so, it tries to solve effectively the problem of accounting for leases where there is a separation of legal title from benefits and risks of ownership.

Finally, it now seems appropriate to give a simple example of the relationship between SSAP 21 and FRS 5. Consider a three-year lease of a warehouse costing £10,000 and having an estimated residual value after three years of £3,000. The present value of the rental payments is £7,000. At the end of the three-year primary lease period, the warehouse is sold. If the proceeds are more than £3,000, the lessee receives the profit. If the warehouse is sold for less than £3,000, the lessee bears the first £1,000 of loss, after which the lessor bears any further loss. The lessee guarantees £7,000 of rentals, plus £1,000 of residual, which under SSAP 21 together are less than 90 per cent of initial fair value — the lease would be accounted for as an operating lease. In practice, the lessee is bearing all the risk that is likely to exist, and the lease is finance in substance. According to FRS 5 the lease should be treated as a finance lease in the accounts, as both an asset and a liability are created for the lessee under the transaction. However, under FRS 5 the lessee needs to capitalise the rights it has acquired — that is, £7,000, being the present value of three years' use of the warehouse. This amount of £7,000 is also the unavoidable obligation of the lessee,

so should also be shown as a liability in the accounts.

To summarise, the existing UK accounting rules on lease accounting are contained in the SSAP 21 and FRS 5 accounting standards. SSAP 21 contains a 'rule of 90 per cent' that must be applied before a company accountant can ascertain whether the lease should be capitalised on the balance sheet as a finance lease, or merely treated as an operating lease. However, in situations where the 'substance' of the lease is finance in nature, FRS 5 applies and forces the company to capitalise on the balance sheet the unavoidable obligations and rights acquired from the lease. The application of these rules is obviously at the mercy and judgement of the individual accountant, but it must be remembered that the accounts have to be audited by an independent accountant who checks for proper application of relevant standards.

The introduction of FRS 5 has clearly cut a company's ability to structure leases in a manner which avoids the SSAP 21 'rule of 90 per cent'. Without this safeguard, by having a lease classified as an operating lease a lessee is able to remove the liability associated from the balance sheet. The next section will examine why this is so important and explain exactly why 'off-balance' financing is common and how it can affect reported accounting performance.

IMPORTANCE OF LEASE ACCOUNTING FOR REPORTED PERFORMANCE

How lease agreements are reported in the annual accounts may appear relatively unimportant to the property professional more concerned with negotiating lease length or dilapidation liabilities and the property user running a business on a daily pragmatic basis. However, the classification of a lease has important implications for the reported level of corporate indebtedness, the calculated gearing ratio, corporate borrowing ability and other commonly used measures of performance. If, for example, a lessee company could justify treating a finance lease as an operating lease, it would then effectively render the financial obligations of the lease contract 'off balance sheet', thereby excluding itself from having to show the financial liability of the lease on its balance sheet at all. This 'off balance sheet financing' is a long-practised form of creative accounting and is something that the ASB has been trying to prevent. Left unchecked, such abuses exaggerate the apparent attractiveness of companies and mislead investors.

Lease accounting impact on reported performance: An example

The performance implications of lease accounting can be illustrated by returning to the example of A Ltd. Table 3 showed extracts from the accounts at the end of the first year of the lease if it was considered a finance lease, with an asset and an associated liability being shown in the accounts. How would this form of accounting affect certain measurements of A Ltd's performance? Well, it would first depend on the existing capital structure of the company before it signed the lease agreement.

Column 1 of Table 4 gives A Ltd's balance sheet immediately *prior* to it signing the lease agreement with B Ltd, where it had fixed assets worth £100,000, current assets of £20,000, no short-term creditors and £20,000 of long-term debt. Let us assume for simplicity that during the year 2000 A Ltd gains £20,000 profit in cash from trading.

If the lease with B Ltd is treated as a finance lease, then, *ceteris paribus*, the

Table 4: Performance measurements compared

	1	2	3
Date of balance sheet	Prior to signing	At 31st Dec 2000	At 31st Dec 2000
Accounting treatment for lease	lease	**As finance lease**	**As operating lease**
Balance sheet	£	£	£
Fixed assets (after depreciation)	100,000	127,894	100,000
Current assets (cash)	20,000	30,000	30,000
Less creditors: due within one year	0	8,264	0
Less creditors: due in more than one year (long-term debt)	20,000	39,091	20,000
Net assets (shareholders' funds)	100,000	110,539	110,000
Gearing ratio* Long-term debt/shareholders' funds	20%	35.3%	18.1%
Lease charge to profit and loss for 2000	N/A	9,461	10,000
Overall profit for 2000		10,539	10,000
Return on total assets†		6.6%	7.6%

Notes: *The gearing ratio is the ratio of long-term debt to shareholders' funds.
†Return on total assets is the ratio of profits to total assets invested in the company.

balance sheet at 31st December, 2000 would be as shown in column 2 of Table 4. During 2000, A Ltd pays £10,000 cash to B Ltd and charges the profit and loss account with the finance charge and depreciation for the year. From column 2, it can be seen that the finance lease increases both the assets and liabilities of A Ltd at the end of the first year.[15] If we include the trading income of £20,000 cash, we can see that the cash increases by £10,000 (£20,000 income less lease payment of £10,000), and the overall profit is £10,539.

With the lease accounted for as a finance lease, the company has a greatly increased gearing ratio of 35.3 per cent from the existing 20 per cent. If the firm enters into further leases, we can clearly see that the reported gearing level might hamper its future ability to borrow.

Let us now suppose that A Ltd could somehow restructure the clauses of the lease to fit in with the definitions of an operating lease under SSAP 21. If we consider column 3 of Table 4, this is the reported result of the lease as if it was accounted for as an operating lease. It can be clearly seen that the overall gearing of A Ltd now *declines* to 18.1 per cent. Effectively, the lease is now 'off balance sheet' and the company is disguising the risks and rewards associated with the leased asset from the users of accounts.

In addition to the gearing distortions, the choice of lease accounting treatment can also affect the reported profitability of a company. If we consider the overall profit of A Ltd in the above example, it is clear that both the returns on total assets and the overall profitability of the firm can be creatively distorted in the early years of a lease. For A Ltd, the return on investment during the year 2000 is increased by 1 per cent just by accounting for the lease as an operating rather than a finance lease. Clearly, this could have a major impact on the perceived attractive-

ness of the firm to new and existing investors.

Although the above example produced substantial differences in reported accounting performance, it must be remembered that the total payments payable *over the life of the lease* will be exactly the same, regardless of the accounting treatment adopted. The distinction in accounting treatment between operating and finance leases simply causes short-term differences in reported performance. However, for a property user with a large portfolio of continuing and newly leased property such differences may be extremely important.[16]

To summarise, reporting a lease as a finance lease rather than an operating lease has important implications for the level of gearing and corporate indebtedness reported in the accounts. Seen in isolation this may not appear important, but it could seriously hinder the strategic and operational ability of certain types of property users. Such concerns may well grow if the ASB's proposed reforms of lease accounting come into force, as explained in the following section.

RADICAL PROPOSALS FOR LEASE ACCOUNTING

The main problem faced by the ASB is that, as explained in the introduction, the leasing market is facing constant change in the light of client demands. The leases that property companies are designing and signing are continually evolving and becoming ever more complex. The ASB needs to consider how the accounting definitions and rules on leases can keep up with the changes in the leases. As with all accounting issues, the ASB remains strongly committed towards providing accounting standards that enhance transparency and improve comparability of financial statements.[17] SSAP 21 has not been revised since 1984, and was only supplemented by FRS 5 in 1994. The ASB has long believed that some reform of lease accounting is needed and has been involved in the preparation of two radical discussion papers on the subject.

In recognition of the apparent deficiencies in international lease accounting, a G4 + 1 Special Report on lease accounting, 'Accounting for Leases: A New Approach-Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts', was published in 1996. The paper proposed that the present distinction between finance leases and operating leases should be replaced with a single method of accounting that applies to all leases. This change was justified by claims that the comparability (and hence usefulness) of financial statements would be enhanced if the differing treatments of operating leases and finance leases were replaced by an approach that applied the same requirements for all leases. Under the proposals put forward, all leases would have to be fully capitalised on the balance sheet, as they all give rise to material assets and liabilities.

The ASB in 1999 published a discussion paper, 'Leases: Implementation of A New Approach', developed from the 1996 G4+1 report and suggesting the same basic reforms to lease accounting, whereby all leases should be capitalised on the balance sheet.[18] The paper adopts a 'financial components' approach, whereby the mere minimum legal rights and committed obligations under a lease should be shown on the balance sheet alongside the legal rights acquired. Accordingly, lease transactions should be considered by reference to their *legal form*, in direct opposition to the current rules contained in FRS 5, which stresses the *substance* of the transaction over the mere *legal form*.

Currently a proposal under discussion,

the ASB has now completed the consultation process seeking responses from all interested parties.[19] The proposed changes to UK lease accounting are of potentially vital significance to property professionals and property users alike. If implemented, the proposals could certainly force more leases back 'on' to the balance sheet, thereby affecting the reported performance of companies with substantial holdings of leased assets. This is something that must be recognised and appreciated by the property profession and property users; it once again raises the spectre of the 'economic consequences' of accounting on property issues.[20]

PERFORMANCE IMPLICATIONS OF LEASE ACCOUNTING REFORM

Under the proposed lease accounting changes issued by the ASB, *all* leases would be accounted for as finance leases. Such a change would affect not only the balance sheet but also the profit and loss account. Accounting for former operating leases in the same manner as finance leases completely changes the way that lease expenses are reported in the profit and loss account. In such cases, yearly lease expenses will no longer form a constant charge (which usually matches the rentals payable) but a declining amount representing depreciation coupled with a finance charge on an amortising loan. In addition, the balance sheet will now include greater new liabilities that represent the unavoidable legal obligations under the lease. Obviously, the impact of the proposed changes will be similar to the example produced earlier in Table 4. Lessee companies with large numbers of operating leases will obviously be most affected by the proposed changes. The accounting liabilities reported on the balance sheet will be substantially greater, thereby forcing up the gearing levels of the firm still further.

In an effort to illustrate this potential impact, Beattie, Edwards and Goodacre found in their 1998 survey of operating lease use by 300 listed UK companies that, on average, the unrecorded long-term lease liability represented 39 per cent of reported debt, while the unrecorded asset was 6 per cent of total assets. Capitalisation of such operating leases was found to have a significant impact on the profit margin, return on assets and gearing of each company:

> 'The potential economic consequences of a change in lease accounting regulation are extensive. Prior empirical studies indicate that a wide variety of individual users' decisions, market valuations, company cash-flows, and managers' behaviour may well be all affected by such a change'.[21]

Despite the potential impact on reported performance, the new lease accounting rules are not without their problems, and these may grant an entity the ability to reduce the impact they make on reported performance. It is to these problems that the paper will now turn.

NO PANACEA: NEW ACCOUNTING — NEW PROBLEMS

It is clear that the new rules potentially have immense consequences on the performance reported in the annual accounts of certain entities. However, a number of potential problems with the proposed rules must be recognised. Primary among these is the ability of the leasing industry to change the nature and characteristics of a lease. This has happened before, fuelled by a constant desire to circumvent the accounting rules and
fairly remove lease liabilities from the

balance sheet. Paterson (2000)[22] is very doubtful that the ASB's new rules will result in any more lease debt being brought back onto the balance sheet:

> 'A leasing industry that has nimbly skipped around the existing standard [SSAP 21] would not take long to relearn the rules of the game and develop new products to suit new circumstances.'

It is also clear from the earlier introduction that property users are already moving towards shorter leases for commercial reasons, and it may not be they who bear the burden of the new reporting requirements. While the rules on leasing may be 'tightened up', the lack of an agreed conceptual framework in UK accounting[23] may still allow leases to be excluded from the published accounts. As was discussed earlier in this paper, lease accounting may well have its own specific standard, but it is not totally self-contained. The current SSAP 21 and the proposed new standard are partly derived from, conflict with and are reliant on elements and concepts contained in other standards, such as FRS 5. In the absence of anything approaching a unified conceptual framework for UK accounting, conflicts and loopholes between, and within, standards may allow the possibility of creative accounting. Unfortunately, there is little the ASB can do about this situation except to revise and issue future accounting standards using a more unified and integrated approach. Accounting abuses in other areas have effectively limited the ability of the ASB to draft 'watertight' new proposals on lease accounting. Such concerns and their solution are obviously beyond the remit of this current paper, but suggest that the proposals for lease accounting reform may take another direction before they come into force as an actual accounting standard.

The most obvious source for creative circumvention of the ASB's proposed new rules on lease accounting would be through the accounting rules governing the actual recognition and definition of liabilities. This can best be explained by looking at how the proposals of the discussion paper fit alongside those currently contained in FRS 5. As they are currently written, the ASB's lease accounting proposals are inconsistent with those of FRS 5 and could lead to its subsequent abolition. As outlined earlier in the paper, FRS 5 includes rules that govern the recognition of assets and liabilities in the accounts, seeking to report the actual commercial substance of transactions rather than their mere legal form. In contrast to FRS 5, the ASB lease proposals within the 1999 discussion paper will report the strict legal rights and obligations under a lease transaction, rather than the actual commercial substance. Immediately, one can see the apparent conflict between the two approaches. If the ASB lease proposals contained within the discussion paper are actually incorporated into a new leasing standard, the current FRS 5 would have to be either abolished or revised to bring it into line with the 'financial components' methodology used by the discussion paper. While this may not appear problematic, FRS 5 has been the chief — and most successful — weapon of the ASB in combating many different forms of 'off balance sheet' financing that used to be prevalent in UK accounting practice. Lease accounting is just one area where 'off balance sheet financing' is a major issue. The abolition of FRS 5 in favour of a 'financial components' lease model might well allow 'off balance sheet' financing to become prevalent once again in all areas of accounting, not just in

lease accounting. Thus, the ASB's lease reforms might not actually result in the capitalisation of all the obligations under leases, especially in the longer term when creative accountants and property managers devise lease clauses in a manner that reduces the *legal* obligations or commitments of a lease.

The above problem is best explained through the use of a simple example. Suppose, for example, a lessee enters into a 10-year lease on a building at £1m a year, with the fair value of the building being £10m. The terms of the lease allow the lessee to cancel it at any time, but if cancelled then the lessee must sell the asset, retaining any profit or loss on disposal. Under FRS 5, the lease would be capitalised 'on balance sheet', as the risks and rewards of ownership had effectively passed to the lessee. Under the proposals of the ASB discussion paper, this lease would be entirely off balance sheet, as there was no committed lease outflow and the sale transaction would have not taken place. The minimum lease payment on applying the discussion paper would be one year, which would result in a fundamental change away from the principles of FRS 5. Thus the proposals in the discussion paper would lead to transactions being considered only by reference to their legal form and could result in a whole new industry of 'off balance sheet financing'.

So although the proposals of the ASB discussion paper aim to get all leases capitalised in the balance sheets of lessees, they may eventually fail to do so. The use of a 'financial components' approach to capitalisation may lead directly to the development of new types of leases that include frequent break clauses in an effort to evade the proposals to include all leased assets and liabilities on the balance sheet. Although the terms on which such lease clauses may be exercised are highly unlikely to happen, such clauses will effectively limit the lessee's unavoidable *legal* obligations under the lease to a small amount at any one time. As a defence against this, the original G4+1 paper and the ASB discussion paper both suggest that where the entity was 'compelled' by practical considerations to keep an asset beyond the minimum contracted term, it should account for the rentals payable over that longer period. However, this defence has problems in defining exactly what 'compelled' actually means in practice. Any decision is arbitrary.

In essence, then, the ASB proposals on lease accounting reform may be rendered impotent by new forms of lease agreement that contain complex clauses in a bid to circumvent them. Once again, a battle between the rules introduced by the ASB and the creativity of the individuals drawing up lease agreements will determine the practical results of the changes. In addition, as was discussed at the commencement of the paper, regardless of accounting proposals, changes in business practice concerning shortening of leases might negate the entire premise behind the rule changes. On the other hand, at times when the landlord is in the ascendant, it might be argued that accounting pressures are less immediate to lessees, who will find themselves in a weaker position to negotiate their requirements within a lease agreement. In any event, the proposed accounting changes will reflect upon commercial practice.

Of course, until the new standard is published it is unclear what it will actually mean for property companies holding large portfolios of leased assets. For such companies, especially those holding operating leases, it is likely to prove financially beneficial in terms of their reporting requirements to shift their property portfolios into certain types of

lease agreements that offer a short-term positive influence on their accounting performance. This suggests that the new financial reporting standards will lead to strong pressure for leasehold tenants to demand either short leases or short-term break clauses in long leases. In addition to changing commercial practice in many regions, this suggests that that the long-term lease is unlikely to survive, unless lessees are willing to accept heavy reporting penalties. This, in turn, suggests that the entire process of property development and lease negotiation must reflect these changes. Financial reporting liabilities for leases will become in themselves a charge that must be paid for and be reflected in the development process. Finally, and just as importantly, the potential abolition of FRS 5 under the ASB's lease reforms may well have similar consequences for the structuring, recognition and reporting of other types of liabilities within UK accounts and may thereby open up a whole episode of 'off balance sheet financing'.

Conclusion

It is likely that the result of these developments will be that leases become much more complicated, as additional clauses are introduced to circumvent any accounting standard that relies on conditional rules. As Paterson (2000) points out *inter alia*[24] this may be to the detriment of the lessees, investors and property professionals. 'Substance over form' has been a rallying cry for UK standard setters for a long period of time. In the battle over lease accounting this continues to be a tough term to bring to bear. Now that the ASB proposals have been published and the consultation period has been completed, only time — and perhaps further consultation — will show the form which the ASB revisions to lease accounting will ultimately take. What is clear is that property users, owners, professionals and valuers have a more pragmatic interest in this issue than do accountants seeking to rationalise their intellectual framework in isolation. In addition, those developments outlined in the introduction as simple commercial decisions will clearly now have additional motivation from the onerous lease accounting being proposed. Lessees must obviously seek to minimise their financial reporting obligations through careful construction of their leases and insistence on shorter terms and break clauses. This is no longer a reflection of changing business practice, but a necessary part of the reporting function. In turn, this will force developers to re-appraise their own decisions in offering properties for lease. Shorter leases will also lead to more expiries and to associated dilapidations claims and disputes affecting building surveyors and general practice surveyors. It is clearly not the purpose of this paper to develop these issues, and it is not feasible to do so until the new regulations are drafted, but all those involved with leased property need to prepare for change.[25]

References

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(5) See for example Coppin, L. (2000) ‘Lease Rebellion on Cards’, *Estates Gazette*, 17 June, p. 62; Crosby, N. *et al*. (2000) ‘Monitoring the Code of Practice for Commercial Leases’, DETR, London; Crosby, N. and Murdoch, S. (2000) ‘Decoding Lease Structures’, *Estates Gazette*, 20 May, pp. 153–156; Maguire, J. (1998) ‘Work Grows as Leases Sink’, *Property Week*, 23 January, p. 32; Rose, A. (2000) ‘Retailers Prepare Fight for Flexibility’, *Estates Gazette*, 17 June, p. 61.

(6) See for example Bradshaw, M. (2000) ‘Selling Upward-only Ban to Labour’, *Property Week*, 1 September, p. 22; Ellison, W. (2000) ‘The Long and Short of It’, *Estates Gazette*, 14 October, pp. 107–108; Harrold, R. (1993) ‘The Cost of Prohibiting Upward-only Rent Reviews’, *Estates Gazette*, 20 November, p. 169; Raynsford, N. (2000) Letter to the editor, *Property Week*, 3 November, p. 27; Roberts, J. (2000) ‘Onwards is Still Only Upwards in Lease Talks’, *Estates Gazette*, 9 September, p. 35; Smith, K. (2000) ‘Raynsford on the Rampage’, *Property Week*, 1 September, pp. 10–11; Welsh, J. (2000) ‘Rents Can Go Down as Well as Up’, *Property Week*, 3 November, p. 25.

(7) This is obviously contingent upon the standard being completed. The initial discussion paper prior to the consultation process has only just been completed. The standards within this paper remain valid until the adoption of the new standard.

(8) See ref. 1 above.

(9) The following are full references to all standards referred to within this paper: ASB (1984), ‘SSAP 21: Accounting for Leases and Hire Purchase Contracts’, ASB, London; ASB (1994), ‘FRS 5: Reporting the Substance of Transactions’, ASB, London; ASB (1999) ‘Leases: Implementation of a New Approach’, ASB, London; ASB (2000) ‘Responses to Discussion Paper “Leases: Implementation of a New Approach” ’, ASB, London.

(10) These calculations are beyond the scope of this paper, but are contained within the appendix to SSAP 21.

(11) ASB (1994), see ref. 9 above, at p. 427.

(12) ASB (1994) (ref. 9 above) at para. 45.

(13) ASB (1994) (ref. 9 above) at para. 57.

(14) ASB (1994) (ref. 9 above) at para. 56.

(15) The actual amounts for these were shown in Table 4.

(16) As mentioned previously, this is also mirrored within the accounts of the company owning the properties.

(17) An issue developed within our previous paper; see ref. 1 above.

(18) For ASB (1999) see ref. 9 above.

(19) ASB (2000); see ref. 9 above.

(20) A further issue developed in our earlier paper (ref. 1 above).

(21) Beattie, V., Edwards, K. and Goodacre, A. (1998) ‘The Impact of Constructive Operating Lease Capitalisation on Key Accounting Ratios’, *Accounting and Business Research*, Vol. 28, No. 4, pp. 233–254; quotation at p. 253.

(22) Paterson, R. (2000) ‘A New Lease of Strife’, *Accountancy*, December, p. 93.

(23) Our earlier paper (ref. 1 above) offers a detailed description of the problems this causes for UK accounting in general and property in particular.

(24) See ref. 22 above.

(25) The exact nature of the new proposals and a detailed discussion of the arguments advanced in response to the initial discussion paper are beyond the scope of this paper.