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PAGE ONE

How Leases Play A Shadowy Role In Accounting

Despite a Post-Enron Push,
Companies Can Still Keep
Big Debts Off Balance Sheets

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Despite the post-Enron drive to improve accounting standards, U.S. companies are still allowed to keep off their balance sheets billions of dollars of lease obligations that are just as real as financial commitments originating from bank loans and other borrowings.

The practice spans the entire spectrum of American business and industry, relegating a key gauge of corporate health to obscure financial-statement footnotes, and leaving investors and analysts to do the math themselves. The scale of these off-balance-sheet obligations -- stemming from leases on everything from aircraft to retail stores to factory equipment -- can be huge:

- **US Airways Group Inc.**, which recently filed for Chapter 11 bankruptcy protection, showed only \$3.15 billion in long-term debt on its most recently audited balance sheet, for 2003, and didn't include the \$7.39 billion in operating-lease commitments it had on its fleet of passenger jets.
- Drugstore chain **Walgreen Co.** shows no debt on its balance sheet, but it is responsible for \$19.3 billion of operating-lease payments mainly on stores over the next 25 years.
- For the companies in the Standard & Poor's 500-stock index, off-balance-sheet operating-lease commitments, as revealed in the footnotes to their financial statements, total \$482 billion.

Debt levels are among the most important measures of a company's financial health. But the special accounting treatment for many leases means that a big slice of corporate financing remains in the shadows. For all the tough laws and regulations set up since Enron Corp.'s 2001 collapse, regulators have left lease accounting largely untouched. Members of the Financial Accounting Standards Board say they are considering adding the issue to their agenda next year.

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"Leasing is one of the areas of accounting standards that clearly merits review," says Donald Nicolaisen, the Securities and Exchange Commission's chief accountant. The current guidance, he says, depends on rigidly defined categories in which a slight variation has a major effect and relies too much

on "on-off switches for determining whether a leased asset and the related payment obligations are reflected on the balance sheet."

A case in point is the "90% test," part of the FASB's 28-year-old rules for lease accounting. If the present value of a company's minimum lease payments equals 90% or more of a property's value, the transaction must be treated as a "capital lease," with accounting treatment akin to that of debt. If the figure is slightly less, say 89%, the deal is treated as an "operating lease," subject to certain other conditions, meaning the lease doesn't count as debt. The lease commitment appears not in the main body of the financial statements but in footnotes, often obscurely written and of limited usefulness.

The \$482 billion figure for the S&P 500 was determined through a Wall Street Journal review of the companies' annual reports. That's equivalent to 8% of the \$6.25 trillion reported as debt on the 500 companies' balance sheets, according to data provided by Reuters Research. For many companies, off-balance-sheet lease obligations are many times higher than their reported debt.

Given the choice between leasing and owning real estate or equipment, many companies pick operating leases. Besides lowering reported debt, operating leases boost returns on assets and often plump up earnings through, among other things, lower depreciation expenses.

"It's nonsense," Trevor Harris, an accounting analyst and managing director at Morgan Stanley, says of the 90% rule. "What's the difference between 89.9% and 90%, and 85% and 90%, or even 70% and 90%? It's the wrong starting point. You've purchased the right to some resources as an asset. The essence of accounting is supposed to be economic substance over legal form."

This summer, **Union Pacific Corp.** opened its new 19-story, \$260 million headquarters in Omaha, Neb. The railroad operator is the owner of the city's largest building, the Union Pacific Center, in virtually every respect except its accounting.

Under an initial operating lease, Union Pacific guaranteed 89.9% of all construction costs through the building's completion date. After completing the building, the company signed a new operating lease, which guarantees 85% of the building's costs. Unlike most operating leases, both were "synthetic" leases, which allow the company to take income-tax deductions for interest and depreciation while maintaining complete operational control. A Union Pacific spokesman declined to comment.

Neither lease has appeared on the balance sheet. Instead, they have stayed in the footnotes, resulting in lower reported assets and liabilities. On its balance sheet, Union Pacific shows about \$8 billion of debt, while its footnotes show about \$3 billion of operating-lease commitments, including for railroad engines and other equipment.

The 90% test goes to the crux of investor complaints that U.S. accounting standards remain driven by arbitrary rules, around which companies can easily structure transactions to achieve desired outcomes.

It means different companies entering nearly identical transactions can account for them in very different ways, depending on which side of the 90% test they reside. Meanwhile, as with disclosures showing employee stock-option compensation expenses, most investors and stock analysts tend to ignore the footnotes disclosing lease obligations.

Three years ago, Enron's collapse revealed how easily a company could hide debt. A big part of the energy company's scandal centered on off-balance-sheet "special purpose entities." These obscure partnerships could be kept off the books -- with no footnote disclosures -- if an independent investor owned 3% of an entity's equity. Responding to public outcry, FASB members eliminated that rule and promised more "principles-based" standards, which spell out concise objectives and emphasize economic substance over form, rather than a "check the box" approach with rigid tests and exceptions that can be exploited.

The accounting literature on leasing covers hundreds of pages. The FASB's original 1976 pronouncement, called Financial Accounting Standard No. 13, does state a broad principle: A lease that transfers substantially all the benefits and risks of ownership should be accounted for as such. But in practice, critics say, FAS 13 amounts to all rules and no principles, making it easy to manipulate its strict exceptions and criteria as needed. One key rule says a lease is a "capital lease" if it covers 75% or more of the property's estimated useful life. One day less, and it can stay off-balance-sheet, subject to other tests.

The FASB, a private-sector body in Norwalk, Conn., that sets generally accepted accounting principles, is considering tackling the issue. Separately, the SEC this year is expected to finish a broad study on off-balance-sheet financing, including leasing.

Many finance executives say changes aren't needed. "I think the current rule has worked pretty well for quite a long time, and in the absence of some compelling reason, I think I would focus the accounting-rule makers' efforts on more urgent tasks," says David Rickard, chief financial officer of drugstore chain CVS Corp. and a member of the FASB's advisory council. "On the other hand, as a practical matter, if they wanted to redraft the standard in a more principles-based way, I think it would be easier for us to use."

FASB Chairman Bob Herz says he thinks "lease accounting is probably an area where people had good intentions way back when, but it's evolved into a set of rules that can result in form-over-substance accounting." He cautions that an overhaul wouldn't be easy: "Any attempts to change the current accounting in areas where people have built their business models around it become extremely controversial -- just like you see with stock options."

Indeed, entire industries have sprung up around the leasing rules for what's on the balance sheet and what isn't. The Equipment Leasing Association, an Arlington, Va., trade group, estimates that 80% of U.S. companies lease all or some of their equipment, and spent \$208 billion last year doing so. About a third of all capital expenditures in the U.S. are done through leases, and more than three million people now work in the leasing industry. That includes boutique consulting firms and divisions of large financial-services companies that advise clients on structuring transactions to get the maximum tax and accounting benefits.

Many leasing companies, big and small, tout those benefits in sales pitches to customers. On its Web site, **Sun Microsystems Inc.**'s finance division promotes leasing as a way "to keep the asset off your balance sheet," and "circumvent the restrictive covenants imposed by many banks." The Web site of MidSouth Fleet Leasing, a Shreveport, La., auto-leasing company, states: "Makes your financial statements look better to a

banker!"

When UAL Corp., parent of United Airlines, filed for Chapter 11 bankruptcy protection in December 2002, its most recently audited balance sheet showed \$25.2 billion of assets and \$22.2 billion of liabilities. Not included: \$24.5 billion in noncancellable operating-lease commitments, mostly for aircraft.

UAL's financial filings noted those were "sometimes referred to as off-balance-sheet debt." Indeed, in bankruptcy court, the companies that leased those planes to United are treated as secured creditors. A UAL spokeswoman acknowledges the company's high lease costs were a factor in UAL's bankruptcy. Since then, UAL has lowered its annual lease costs by \$900 million.

US Airways says the primary cause of its Chapter 11 bankruptcy filing this month was its inability to reduce labor costs by \$800 million. However, the footnote disclosures about its lease obligations show the company was far more leveraged headed into bankruptcy court than its balance sheet had indicated. This was the second bankruptcy filing for US Airways since August 2002, after which the company negotiated lower operating-lease costs for its fleet, among other cost reductions. Asked about the accounting for its aircraft leases, US Airways spokesman David Castelveter says: "The rules are the rules, and we abide by the rules."

Many retailers favor operating leases over capital leases. **Winn-Dixie Stores Inc.**'s reported debt of about \$300 million is just 30% of its shareholder equity. That healthy ratio might seem comforting at a time when the Jacksonville, Fla., grocery chain is restructuring its business after years of declining sales and market share.

The footnotes show a far more leveraged company. Its off-balance-sheet obligations at June 30 included about \$4.1 billion of noncancellable commitments over several years to lease the buildings for its stores.

Such lump-sum totals are little help for outsiders looking to recreate how a company's balance sheet would look if operating leases were counted as assets and debt. For instance, if a company's stores are depreciating rapidly, the rights to lease those stores -- the asset part of the equation -- may be worth far less than the present value of the company's future lease obligations. The standard footnote disclosures, published once a year, say little about the terms of a company's leases, like when they began. Depreciation schedules and interest rates are tough to estimate.

At Morgan Stanley, Mr. Harris and another analyst, Elmer Huh, recently tried to calculate the effect of including operating leases on Winn-Dixie's latest annual balance sheet. Their best guess: an extra \$2.8 billion to debt and just \$1.7 billion to assets, resulting in lower shareholder equity and earnings. A Winn-Dixie spokeswoman says, "The operating lease liabilities are disclosed as required by GAAP and are well-known to both the rating agencies and our lenders."

Walgreen, with its \$19.3 billion of operating-lease payments over the next 25 years, would show slightly lower earnings and shareholder equity if leases were brought on its balance sheet, according to Morgan Stanley estimates. Walgreen executives declined to comment on the estimates, but they said they don't structure their leases with accounting outcomes in mind.

Meanwhile, because of differing circumstances, other companies with large operating-lease obligations would show slightly higher earnings and equity if their leases were on the balance sheet, according to

Morgan Stanley. Among them: CVS, the drugstore chain, whose latest annual report shows \$1.1 billion of debt and \$10.8 billion in off-the-books lease commitments. Mr. Rickard, the finance chief, says CVS prefers leasing to owning stores because it doesn't want exposure to volatile real-estate markets.

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