

## DEFUSING SYNTHETIC LEASE OFF-BALANCE-SHEET TIME BOMBS

Leases can be separated into two groups for financial and tax accounting purposes: operating leases and capital leases. Operating leases convey to lessees use-related possessory rights in property not so extensive as to constitute investment positions. Capital leases convey more extensive rights construed as investment positions.

Financial and tax accounting rules view property title holders as the true owners in the case of operating leases. In contrast, the rules view lessees as the true owners in the capital lease case and title holders as mortgagees. In this case, the rules require lessees to list the properties as balance sheet assets and capitalized net future rent as balance sheet debt.

A synthetic asset is a financial asset associated with an identifiable entity, but which was not issued by the entity as that type of asset. The synthetic lease is a synthetic asset that was developed to provide companies with off-balance-sheet finance for property acquisitions. The label *synthetic lease* is inaccurate: a correct descriptive label would be *synthetic operating lease*.

Synthetic lease rents and terms are selected to satisfy FASB criteria for operating leases. However, for the past decade the FASB perspective on synthetic leases has appeared economically incorrect to many observers, see [3], [7], [8], [9]: use-related leases do not require the lessee to reimburse the lessor for any decline in property value; neither do use-related leases convey the value of any property appreciation to the lessee when the property is sold. These are capital lease characteristics.

Following revelations that synthetic leases played prominent roles in the Enron and Global Crossing accounting fiascoes that led to bankruptcy for both corporations, FASB is tightening requirements for operating leases, i.e., for off-balance-sheet financial accounting status. The primary changes are that property title holders must invest more equity capital than previously required, and the leases cannot guarantee the equity capital against investment loss.

The new requirements do not grandfather preexisting leases. It follows that synthetic leases crafted under the old standards will become capital leases: the property will be added to lessee balance sheet assets and the capitalized leases added to lessee balance sheet debt.

The new requirements are being phased in, applying initially to new leases and later to preexisting leases. This presents lessees in preexisting synthetic lease structures with a window of opportunity to restructure property ownership and leases in order to keep the property and capitalized leases off the lessee balance sheets.

Lessees essentially have four alternatives: do nothing and allow the synthetic lease to become a capital lease; do a sale-leaseback with a conventional use-related operating lease and lessor; sell the property into a replacement synthetic lease structure that meets the new operating lease requirements; or sell the property into a synthetic debt all-equity structure with a conventional use-related operating lease.

The do-nothing alternative leaves lessees with no benefit to show for the incremental expense and risk of setting up synthetic lease capitalizations. The sale-leaseback surrenders lessee participation in property investment potential or creates tax-burdened pass-through debt service that constrains lease term and rent. The replacement synthetic lease maintains a misleading capital structure for financial reporting purposes that is also the riskiest capital structure, see [3], and the lessee risks further FASB tightening of operating lease criteria that could transform more synthetic leases into capital leases.

Finally, the synthetic debt structure avoids shortcomings of the other alternatives with a conventional use-related operating lease that minimizes exposure to evolving FASB financial reporting standards and an all-equity capital structure that allows lessee participation in property investment potential with minimal investment risk and tax problems; see [3], [4].