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Hints That Lease Accounting Reform Will Hurt

By Tammy Whitehouse — July 28, 2009

A final rule on accounting for leases is still several years in the future, but financial executives should brace themselves now for a new approach that will probably bring a rush of assets and liabilities onto the corporate balance sheet.

Leasing has been a sore point with regulators for years, since companies routinely structure leasing deals to evade bright-line accounting rules and keep assets off the balance sheet. The Securities and Exchange Commission put a bull's eye on lease accounting rules when it published an extensive study in 2005 about off-balance-sheet accounting, calling for changes to accounting rules to produce financial statements that reflect the economic realities of lease agreements.

That SEC study determined that the undiscounted cash flows associated with off-balance-sheet leases could be as high as $1.25 trillion. The Financial Accounting Standards Board and the International Accounting Standards Board agreed as part of their convergence plan to get a new standard into the books by 2011, and so far have agreed that leases generally give rise to an asset and a liability that should appear on corporate balance sheets.

Ultimately the boards want to end the distinction between operating leases and capital leases as defined in existing rules. Operating leases are treated as simple rental agreements where the expense is reported on the income statement; capital leases, on the other hand, are treated more like the purchase of an asset with financing, leading to an asset and liability reported on the balance sheet.

RELATED RESOURCES

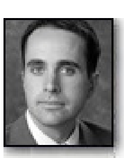
- FASB-IASB Discussion Paper on Leasing (2009)
- IASB Snapshot Review of Leasing (2009)
- Comment Letters on Leasing Reform
- FASB Project Summary of Leasing Rules
- IASB Project Summary of Leasing Rules
- SEC Study on Lease Accounting (2005)
- Podcast on Changes to Lease Accounting (May 12, 2009)

Related Coverage

- FASB, IASB Outline Plans to Rewrite Leasing (March 20, 2009)
- FASB to Expand Approach in Lease Project (Jan. 20, 2009)

The two boards have collected more than 160 comments from all over the world on their preliminary views, and expect to begin discussing the feedback in September, IASB senior project manager Rachel Knubley says. The boards aren't yet certain whether they will publish a joint proposed standard or two separate standards, although they do want to issue something for further comment in the first half of 2010.

While a final rule may still be a few years into the future, already FASB is fleshing out the details of its vision for a new standard—including at least one idea that could be a game-changer for corporations, according to Timothy Shea, a lawyer with the law firm Foley & Lardner who has followed the leasing debate closely. At a meeting earlier this summer, FASB said it wants any final new rule to apply to all existing leases when the rule takes effect, not just new leases going forward.


Shea

That could have a significant effect on companies that are entering into or contemplating new lease agreements even now, Shea says. "What effect is that going to have on your credit rating, debt covenants, or compensation agreements?" he says. "It's not too early to think about those things."

A new approach to lease accounting likely would affect corporate balance sheets in a few significant ways, Shea says. The balance sheet will reflect a greater level of assets and liabilities, potentially causing a company to appear more leveraged, depending on how significant the increases. The rent expense associated with leasing will be replaced with an interest and depreciation expense as part of the asset and liability calculations—which would then change the calculation of EBITDA (earnings before interest, taxes, depreciation, and amortization), a ratio many companies tout as an indicator of economic performance.

Shea says the proposed changes in lease accounting would likely increase EBITDA, which would affect agreements based on EBITDA: bonuses, commissions, or earnout payments, to name a few.

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>
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Rick Smetanka, a partner at the southern California regional accounting firm Haskell & White, says companies should also brace for volatility in the income statement. "I don't hear a lot of people talking about what this is going to do to the income statement, but to me that is the scarier part, particularly for a public company," he says.

First, the straight-line method of expensing a steady rent payment will end, and take a "nice, steady, predictable expense" along with it, he says. Instead, companies will typically report more expense in the earlier years of a lease and less in the latter years.

Smetanka

Another concern, Smetanka says, is the uncertainty that arises when lease payments are based on certain variables, such as changes in the Consumer Price Index or contingencies based on sales. Such provisions will require companies to remeasure the lease liability over time. "If your estimate proves to be bad, you're going to have to adjust the liability. The offset to that is to run it through the income statement," he says. "There is much more volatility we can all expect in the income statement."

No Immediate Panic

Still, uncertainty abounds about exactly what a final rule from FASB and IASB will require, says Jay Hanson, national director of accounting for McGladrey & Pullen and chair of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants. For example, the two boards still aren't agreed on how they will require companies to account for optional renewal features within lease agreements.

Where a company could renew a lease for as little as five years or as long as 20, FASB says a business should just pick the most likely renewal term and account for it directly, then change it as necessary in the future. IASB, on the other hand, says entities should assign probabilities to various possible choices, and then average them out.

FASB LEASING RULES

The following excerpt is from the Financial Accounting Standards Board's summary of leasing rules—decisions and next steps:

Decisions Reached at the Last Meeting (June 17, 2009)

The Board discussed several lessee accounting issues that were not addressed in the Discussion Paper. The Board reached the following tentative decisions:

Sale and leaseback transactions: In a sale and leaseback transaction, a seller/lessee would consider whether the entire leased asset qualifies for derecognition. If the entity determines, after applying the applicable guidance for the underlying asset, that the transaction qualifies as a sale, it would derecognize the leased item and recognize a right-of-use asset and an obligation to make rental payments for the leaseback. The Board will consider whether additional criteria are needed to help entities determine whether a sale and leaseback transaction represents a sale and how to account for a sale and leaseback transaction when the sales prices or rental payments are not at market rates.

Impairment of the right-of-use asset: A lessee preparing financial statements in accordance with international financial reporting standards would follow the guidance in IAS 36, Impairment of Assets, to determine whether its right-of-use asset is impaired and a loss should be recognized. A lessee applying U.S. generally accepted accounting principles would follow FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, to determine whether its right-of-use asset is impaired

Companies could expect a great deal of judgment and complexity under either approach, Hanson warns. "How often do you true that up over time?" he says. He gives the example of Starbucks, with thousands of leased coffee shops around the world. "Doing that every quarter will just be a nightmare for those companies."

Nestle SA, the chocolate and food giant, wrote a comment letter to FASB and IASB that expressed the concerns most companies have right now. To accelerate their work, FASB and IASB decided to set aside the question of lessor accounting (the party that provides the asset and financing) and focus only on lessee accounting (the party that receives the asset and the liability to pay for it).

Nestle worries that starting only with lessees will result in disjointed outcomes, especially for companies that act as both lessees *and* lessors in different transactions. "Different treatments would thus create an imbalance in the accounts of these entities and would impair a fair presentation of their overall leasing transactions," the company wrote.


Bentsen

The Equipment Leasing and Finance Association has plenty of feedback to offer as well. It is not challenging the notion of bringing leased assets onto balance sheets, but is worried about the complexity that will introduce, especially for small companies and small leases. There's an economic difference between a small, short-term lease that looks like a rental agreement and a larger, more substantial lease that looks more like an asset acquisition, says ELFA President Ken Bentsen—but FASB's and IASB's proposed plan makes no allowance for it.

Bentsen says 90 percent of all leases are for less than $5 million in original value, "and the vast majority are even smaller than that." He questions whether that amount is material for larger companies, and whether the accounting will be onerous for smaller companies. "Small and medium enterprises are going to have to engage in pretty complex financial reporting for modest investments in the right to use equipment that doesn't make a lot of sense," he says.

and a loss should be recognized.

Revaluation of the right-of-use asset: A lessee would subsequently report a right-of-use asset at cost adjusted for amortization and impairment losses, if any. A lessee would not be permitted to subsequently remeasure its right-of-use asset to fair value unless required to do so to recognize an impairment loss.

Initial direct costs: A lessee would expense any initial direct costs as incurred.

Transition: A lessee would apply the new lease standard by recognizing an obligation to pay rentals and a right-of-use asset for all outstanding leases at the transition date. The obligation and the asset would be measured at the present value of the lease payments, discounted using the lessee's incremental borrowing rate on the transition date.

Summary of Decisions Reached to Date

Lessor Accounting (see May 2009 minutes and meeting summary): The Boards decided that a lessor would recognize an asset representing its right to receive rental payments from the lessee (a lease receivable) and a liability representing its performance obligation under the lease—that is, its obligation to permit the lessee to use one of its assets (the leased item). The lessor will satisfy that performance obligation (and will recognize revenue) over the lease term.

Lessee Accounting: See decisions reached at the last meeting …

Next Steps

Lessor Accounting—The following issues will be discussed at a future Board meeting:

1. How a lessor would initially and subsequently measure the leased item, the lease receivable, and the performance obligation

2. How a lessor would present the leased item, the lease receivable, and the performance obligation in its statement of financial position

3. What differentiates a sale of an asset from a lease

4. Whether a lessor would apply a right-of-use model to a short-term or immaterial lease.

Source

FASB Project Summary of Leasing Rules.