

Update: The Lease Accounting Project

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BACKGROUND

As discussed in a prior issue of TODAY, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working on a joint project to revamp the standard for how to account for leases.

This project is part of the convergence movement to create one set of global standards. The current U.S. lease accounting standard, known as FAS 13, has been in existence since 1976 and has been widely criticized as being too structured; thereby providing the ability for lease contracts to be manipulated to create a desired result in terms of accounting treatment.

It should be pointed out that the accounting for leases discussed in this article only affects the financial statement presentation of the transaction. Accounting standards do not affect how leases are treated for tax purposes or how leases are interpreted in a legal setting.

The project has already been split into 2 pieces, lessee and lessor rules. The lessee reporting project will be tackled first and the lessor project will be deferred.

TIMETABLE

A preliminary views document is expected to be released in late 2008. This will provide an opportunity for comments from the industry and other interested parties.

A formal exposure draft is expected in 2009. This will be a draft of the proposed statement and, again, provides an opportunity to comment.

The final standard for lessees is expected in 2010 or 2011.

The final standard for lessors is expected in 2013 or later. Therefore, U.S. lessors can expect to continue to follow the current standard (FAS 13) until at least 2013.

ISSUES

Revamping lessee accounting is the priority because: (a) there are a lot more lessees than lessors and (b) there is a perceived need to eliminate "off balance sheet" financing. Currently, many leases such as typical closed end vehicle leases or typical office space leases are not shown as an asset or liability on a lessee's balance sheet. The lease payment for these "operating" leases is currently treated like the phone bill or payroll; it is expensed each month as incurred and no liability is recorded even though there is a long term contractual obligation.

The current "off balance sheet" treatment for operating leases is favorable to lessees and frequently is one of the items considered in a lease vs. buy analysis. Even though recording a lease "on" balance sheet creates an asset on the lessees' balance sheet, it also creates a liability and most lessees would prefer to show as few liabilities as possible as this affects loan covenants, ratios, etc. As mentioned above, under current rules, the lease agreement can be structured to allow this favorable treatment by lessees. Once the new standard is issued, this treatment is expected to be eliminated for most lease transactions.

Changes to the lease accounting rules are not expected to stop with just eliminating "off balance sheet" financing. Although current indications are only preliminary, the concept of what a lease represents is also likely to change. It is probable that the existing concept of "benefits and risks" of ownership will change to "which promises" on the lease contract give rise to rights and obligations.

This change in focus to what obligations exist will likely cause more liabilities to be recorded than just the obligation for the lease payments and, additionally, cause greater complexity for the lessee. These additional items, if they become part of the new standard, will not only take away the ability to create favorable off balance sheet treatment in the lease vs. buy analysis, but will add other negative affects.

The additional potential negative items for vehicle and equipment lessees are:

- 1) The initial liability set up by the lessee might include an amount for: a) contingent rents, such as over mileage charges, b) the purchase option or options to extend or renew the lease and c) maintenance costs for the unit.

Obviously, if these items were required to be treated as a liability, it would require estimation on the part of the lessee and perhaps periodic reevaluation. Creating a larger initial liability due to these issues and forcing the lessee to deal with the related accounting estimates will add to the complexity for the lessee.

- 2) The liability discussed in (1) above would likely be initially calculated by taking the present value of the expected cash outflow. It is expected that the present value calculation would be based on the lessee's incremental borrowing rate.

- 3) The initial asset would probably equal the initial liability as calculated in (2) above, however the preliminary indication is that the asset would be amortized on a straight-line basis but the liability reduction would be treated like a loan amortization with greater interest expense in the early stages of the lease and less interest expense in the later stages. If this becomes part of the final standard, the lessee's P & L will show more expense at the beginning of the lease and less in each subsequent month; instead of the straight-line expense which exists now for operating leases. Again, this would take away a favorable argument in the lease vs. buy analysis.

There are on-going discussions regarding whether to exclude short term (lease terms of less than one year) and immaterial leases from the new rules. No preliminary consensus was reached on this subject as of the time this article was written.

These proposals could result in very significant changes. We will continue to monitor these developments and will respond to the preliminary views document and exposure draft, once they are issued.

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