By Bill Bosco

# GASB Takes on a Project to Change Lease Accounting

## *There Is Risk That It Will Cause the Cost of Municipalities' Debt to Increase*

ON NOV. 11, 2014, the Governmental Accounting Standards Board (GASB) issued a Preliminary Views document on a project to change current GASB lease-accounting GAAP that would conform with the proposed approach in the soon-to-be-completed Financial Accounting Standards Board (FASB)/International Accounting Standards Board (IASB) Leases project. March 6, 2015, was the comment period deadline.

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The preliminary views from the GASB include following the IASB single-lease model for lessees and a direct finance, lease-only model for lessor accounting. Some expert commentators believe this approach would obscure the financial results of municipalities. If enacted as proposed, the new rules would have a bigger impact on real estate transactions and would also negatively affect debt rating, the cost of debt and the availability of credit for state and local government municipalities. Yet another concern is that the GASB approach differs from that of the FASB in the Leases project, which ELFA and other organizations support as best representing the economics of lease transactions in the financial statements of lessees and lessors.

### Background

The current GASB accounting rules incorporate the FAS 13 lease-accounting rules virtually verbatim. Briefly, under both the FASB and GASB rules, lessees account for leases as either operating leases (off-balance-sheet with straight-line rent expense) or capital leases (on-balance-sheet as a depreciating asset and a liability with imputed interest). Lessors account for leases as either direct finance leases (receivables and residuals are the leased assets and finance lease revenue is recognized using the interest method) or operating leases (leased asset is a depreciable asset and rents/residuals are the revenue elements). Also, the GASB rules disregard fiscal funding or cancellation clauses for lessee lease classification and financial reporting purposes if the possibility of cancellation is remote. Fiscal funding clauses are present in leases that qualify as tax exempt (i.e., lessor's revenue is exempt from federal income taxes), also known as municipal leases, which are the most common type of equipment leases employed by municipal government entities. These leases are classified as capital leases (on-balance-sheet as a physical asset and debt) under current GASB GAAP. Typically, operating leases entered into by municipalities involve office space or other real estate leases. They are off-balance-sheet under current GASB GAAP as they are executory contracts under U.S. bankruptcy rules, and, as such, do not create an asset or debt in a bankruptcy liquidation.

### FASB/IASB Proposal

The main objective of the current FASB/IASB Leases project is for lessees to capitalize all operating leases, other than short-term leases, as an asset and liability. The FASB and IASB are not converged on lessee accounting. The IASB would adopt a model that capitalizes all leases, which the GASB follows, with this proposed change. The FASB retains risks-and-rewards–based lease-classification tests in place (with minor changes to remove the "bright lines" present in the FAS 13 classification tests) and treats capitalized operating leases differently from capital leases. Under the FASB approach, the operating lease cost is the straight-line rent expense and the operating lease liability is reported as an "other" liability—not debt. The capitalized lease asset is also separately reported as a right–of-use asset.

Regarding lessor accounting, both the IASB and FASB have decided that current GAAP should not change in any material way. The GASB, on the other hand, is proposing to eliminate the operating lease method for governmental entities that act as lessors. The only area where there appears to be significant municipal leasing as a lessor is in real estate—either as an owner/lessor or a sublessor. The idea of lessor accounting for lease of a part of a building (such as excess office space) as a direct finance lease is not practical as the fair value and residual value are not readily determinable; as such, one cannot calculate the implicit rate in the lease.

### GASB Proposed Approach

The GASB proposes that lessees apply capital lease accounting to *all* leases. It would label the resulting asset an "intangible" asset contrary to the tangible asset that results under current capital lease accounting. The proposed P&L lease cost is *front-loaded*, as interest is imputed on the liability. The liability is considered debt for all leases.

Analysis reveals that such a change by the GASB would not impact ELFA member government lease lessee behavior, as the vast majority of government leases are tax-exempt leases, which, by definition, are capital leases. This means they should all be capitalized now under current GASB GAAP. What would be impacted are the reported results of newly capitalized FMV equipment leases and real estate/office space leases. Under current GASB GAAP, they are off-balance-sheet with level rent expense.

### Impact on Debt Rating Models and Cost of Debt/Bonds

The proposed changes to operating lease accounting will negatively impact three areas that make up 20% of the debt rating "score" in the Moody's muni debt rating scorecard. The areas impacted are operating history (revenue-to-expense ratio), debt to full value (ratio of debt to taxable rate base) and debt to revenue (ratio of debt to tax revenues).

Front-ending lease costs on FMV equipment leases and real estate operating leases will generally deteriorate the operating history ratio under the concept of capital lease accounting for operating leases. It is true that over time the front-loading versus level rent expense is a timing difference and lease costs will generally level as new leases replace old leases. Unfortunately, the reality is the lease cost will be inconsistent or "lumpy" from year to year. The front-ending effect is greater the longer the lease term and real estate leases are medium to long term.

The two debt ratios will worsen as the capitalized operating lease liability is considered a new debt (it is an executory liability that is not debt in a bankruptcy). The result should be deterioration in debt ratings and higher new issue debt costs for the municipality for no reason but a change in thinking by the GASB. The credit quality of the governmental entity will not have changed.

### Impact on Credit Quality

Naturally, a mere change in accounting does not impact the ability of a municipality to meet future obligations; however, the changes will cloud the ability of a lender/lessor/rating agency to understand the financial results where operating leases are present in significant amounts. One can envision a municipality recasting its lease accounting to provide potential lessors and lenders as well as credit rating agencies with the "true picture," an added cost and complexity burden that may be required to get the best bond rating or to receive approval for a new lease or loan.

### Conclusion

The preliminary view that all leases are the same is another example of an accounting theory that has no basis in the legal treatment of leases. The legal treatment is what defines whether a lease creates debt or an asset in reality. While the biggest impact of the proposed change seems to be in the real estate industry, a concern is the possibility of the FASB changing its mind on the two-lease lessee-accounting model tentatively decided in the Leases project. Another concern is that the process of reviewing municipal credits will require more work for lessees and their lenders/lessors. ■

**Bill Bosco** is President of Leasing 101, a member of the ELFA Financial Accounting Committee and a member of the Lease Project Working Group.