

Changes in Lease Accounting: What Should Analysts and Rating Agencies Know About It?



What is the Project?

The FASB & IASB will jointly develop a new lease accounting standard by 2011 dealing with lessee accounting, with lessor accounting to be addressed separately. The objective of the project is to capitalize all material leases on lessees' books. The scope will be leases of PP&E.

The proposal is for the lessee to account for the lease contract's rights & obligations as assets & liabilities. The Boards do not want to classify leases as those where the rights are ownership rights versus those where the rights are rights to use the leased asset. Rather, they want to use the finance lease accounting method in IAS 17 for **all** leases. This is a form-driven rule!

The favored initial measurement is to estimate likely lease payments including estimating renewals, contingent rents, purchase options and residual guarantees and record the PV (using the lessee's incremental borrowing rate) as an asset and a liability. Catch-up adjustments for **any** changes in estimates will be required on reporting dates.

The favored subsequent accounting is to amortize/depreciate the asset on a straight line basis and account for the liability as a loan with imputed interest expense, thus **front ending** the lessee's expense compared to current GAAP for operating lease rent expense (straight line).

Why is the Project Important?

Estimates show that US public companies have \$1.3 trillion in operating lease obligations.

The project will capitalize the obligations but will not reflect the lease asset's true value due to straight line amortization. It will front-end lease expense and under-report operating cash outflows as rent is no longer reported as the expense. It is form driven, failing to distinguish leases that have ownership rights vs. rights of use.

Capitalizing contingent rents is a new concept that will increase capitalized amounts & complexity. Is it a liability if not probable?

Who Will Be Impacted and How?

All companies lease, with real estate representing about 70% of lease volume.

The PV of the lease rents will be recorded as an asset and liability. In a 10 year mall lease with annual rents of \$450,000, the capitalized amount would be \$3,019,537 @ an 8% discount rate.

The P&L pattern **will not** represent the economic nature of a rental agreement as it will be front-ended as level rent expense is replaced by imputed interest on the liability at 8% and straight line depreciation of the capitalized asset. For a 10 year lease with annual rents of \$450,000, the increase in **first year expense is \$94,000 or 21% higher than straight line.**

P&L Pattern	YR 1	YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10	Total
Current GAAP	450	450	450	450	450	450	450	450	450	450	4,500
Proposed GAAP	543	526	508	489	468	445	421	394	366	335	4,500
Difference	(93)	(76)	(58)	(39)	(18)	5	29	56	84	114	0
% Difference	-21%	-17%	-13%	-9%	-4%	1%	6%	12%	19%	25%	0%
Cum % Diff	-21%	-38%	-51%	-60%	-64%	-63%	-56%	-44%	-25%	0%	0%

Capitalizing contingent rent will cause large amounts of "estimated" contingent rents to be capitalized where no "true" liability exists until incurred. The **estimate of future contingent rents would be capitalized at inception**, increasing the asset & liability & exacerbating the front-ending of expense. The estimates would be reviewed & adjusted at each reporting date with complex calculations and catch-up adjustments to be made.

The P&L pattern will not match the IRS tax treatment requiring **deferred tax accounting**.

What Should Be Done?

Affected groups should become involved in the project and comment on the FASB/IASB discussion papers and exposure drafts as they are issued. Only then will the standards-setting bodies be aware of the controversial views taken in the project that **do not reflect economic reality** and the real-life business impact if these rules changes are adopted. The responses have to be based on theoretical arguments like the nature of liabilities, the economics of transactions, the needs of users of financial statements, and clarity in financial statements. **Cost/ benefit and complexity** must be considered as well.

Specifically, the following points should be emphasized:

- 1) The rights in lease contracts must be considered & lease classification is an important distinction for readers of financial statements.
- 2) A straight line expense pattern for P&L reporting more truly reflects the economics of a true lease.
- 3) Certain contingent rents are not liabilities until they are probable to occur.