

# Changes in Lease Accounting: What Should the Banking Industry 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. They want to use the finance lease accounting method in IAS 17 for **all** leases. Rather, they may adopt IAS 17 for lessor acctg causing the **loss of lev. lease accounting**, which will gross up lessors' balance sheets – **a new capital need!**

Initial measurement will be to estimate likely lease payments including estimating renewals, contingent rents, purchase options, and residual guarantee and record the PV (using the lessee's incremental borrowing rate) as an asset and a liability **ballooning balance sheets – a new capital need!** 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 (S/L) – **a new capital need!**

## Why is the Project Important?

Estimates are US public companies have \$1.3 trillion in operating lease payments, which will be capitalized on B/S adding assets & liabilities.

Comparing the current S/L pattern of lessee op lease accounting vs. finance lease accounting will significantly front end lease expense & cause book tax differences that do not reflect the economic impact of leases. The first year increase in lease expense for a 3 year lease is 7% & for a 10 year lease it is 21%!

**When is contingent rent a liability** & what is the value to be recorded? Capitalizing contingent rents will significantly increase capitalized amounts & complexity.

Lease capitalization, recalculating changes in estimates & deferred tax accounting for leases will be **complex & burdensome**.

Leveraged lease acctg = economic reality. Its loss will require more capital and increase lessee costs.

## Who Will Be Impacted and How?

Banks lease branches, office space and IT/office equipment. The PV of the lease rents will be recorded as an asset and liability. In a 10-year RE lease with annual rents of \$450,000, the **capitalized amount would be \$3,019,537** @ an 8% discount rate. A 3-year, PC lease will be **capitalized at \$3,528 or 89% of the \$4,000 cost** assuming 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 the 10 year RE lease with annual rents of \$450,000 the increase in **first year expense is \$94,000 or 21% higher than straight line** – see example:

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%

Similarly, 3 Yr PC/office equip leases will be front-ended where the first year expense will be **7% higher than straight line**.

Contingent rent is common in retail RE leases & will cause large amounts of "estimated" contingent rents to be capitalized at inception where no "true" liability exists until incurred, 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 triggering **deferred tax accounting**.

## What Should be Done?

Lessees and lessee 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 must 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) Leveraged lease accounting reflects the economic nature of the lease and reduces the cost to lessees.
- 4) Certain contingent rents are not liabilities until they are probable to occur.