

Changes in Lease Accounting: What Should Equipment Manufacturers 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 thus **eliminating sales-type lease accounting**. Rather, they want to use the finance lease accounting method in IAS 17 for **all** leases.

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).

Who Will Be Impacted and How?

Captive finance companies will **lose sales-type lease accounting** as there may be no classification of leases that transfer ownership rights.

The PV of the lease rents will be recorded by the lessee as an asset and liability. In a 5-year \$100,000 equipment lease, the PV of rents will be **capitalized at \$89,306 or 89% of cost** assuming a 7% 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 7% and straight line depreciation of the capitalized asset. For a 7-yr auto lease with monthly rents of \$1,689 and estimated mileage charge of \$588, the increase in **1st year expense is \$2,333 or 11% higher than straight line**.

P&L Pattern	YR 1	YR 2	YR 3	YR 4	YR 5	TOTAL
Current GAAP	21,781	21,781	21,781	21,781	21,781	108,905
Proposed GAAP	24,114	23,026	21,863	20,618	19,286	108,905
Difference	(2,333)	(1,245)	(82)	1,163	2,495	0
Difference	-11%	-6%	-	6%	11%	0.0%
Cum % Diff	-11%	-17%	-	6%	17%	0.0%

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

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

Why is the Project Important?

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

Sales-type lease acctg = economic reality where the lease is a purchase/financing & a gross profit exists.

Comparing the current S/L pattern of lessee op lease accounting versus 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 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**

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 enacted. 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) Sales-type lease accounting is appropriate for leases with a gross profit and where they are in-substance sales.
- 3) A straight line expense pattern for P&L reporting more truly reflects the economics of a true lease.
- 4) Certain contingent rents are not liabilities until they are probable to occur.