

Changes in Lease Accounting: What Should the Information Technology 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 concept 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 – **this may kill sales-type lease accounting**. 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).

Why is the Project Important?

Estimates are US public cos have \$1.3 trillion in op 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 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**

Who Will Be Impacted and How?

Captive finance companies will **lose sales-type lease accounting** as there will 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 3-year \$4,000 PC lease, the PV rents will be **capitalized at \$3,528 or 89% of 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 7% and straight line depreciation of the capitalized asset. For a 3-yr lease with no rents of \$110 the increase in **first year expense is \$93 or 7% higher than straight line**.

P&L Pattern	YR 1	YR 2	YR 3	Total
Current GAAP	1,326	1,326	1,326	3,979
Proposed GAAP	1,419	1,329	1,230	3,979
Difference	(93)	(3)	96	-
Difference	- 7.0%	-	7.0%	-
Cum % Diff	-7.0%	- 7.0%	0.0%	-

Capitalizing contingent rent 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 & 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 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.