

Changes in Lease Accounting: What Should the Rail 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 to 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. They favor adopting IAS 17 for lessor accounting thus **killing leveraged lease accounting**.

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?

The PV of the lease rents will be recorded by the lessee as an asset and liability. In a 17-year rail lease the PV rents will be **capitalized at 85-89% 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 22-yr lease of a \$10 million railcar lease, the **first year expense is \$812,000 or 26% higher than straight line**. The difference reaches a **high point in year 12 of 200% of straight line**.

P&L Pattern	YR 1	YR 2	YR 3	YR 4	cum thru YR 12	Total 22 YRS
Current GAAP	812	812	812	812	9,747	17.9
Proposed GAAP	1,037	1,024	1,011	996	11,368	17.9
Difference	(225)	(212)	(198)	(184)	(1,621)	0.0
Difference	-28%	-26%	24%	-23%	-	0%
Cum % Diff	-28%	-54%	-78%	-101	200%	0%

The P&L pattern will not match the IRS tax treatment and as a result **deferred tax accounting will be required**.

Lease pricing will rise due to the loss of leveraged lease accounting for lessors as lessors will have to gross up their balance sheet with non-recourse debt. This change in accounting does not match the lessor's economics in a leveraged lease

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.

Leveraged lease acctg = economic reality and lessee benefits thru lower costs.

Comparing the current S/L pattern of lessee operating 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**

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 and 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 lease and reduces the cost to lessees.
- 4) Certain contingent rents are not liabilities until they are probable to occur.