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Change in Lease Accounting Rules
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Overview

What is the project?

- The FASB & IASB will jointly develop a new lease accounting standard to be applied worldwide by 2011. The project will deal with lessee accounting. Lessor accounting will be considered in a separate project. A Discussion Paper establishing the Boards' preliminary thinking on the project is scheduled to be released in late March 2009
- The objective of the project is to capitalize all material leases on lessees' books.
- The scope will be leases of plant, property and equipment (PP&E).
- The concept is to account for the lease contract's rights and obligations as assets and 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.
- The favored initial measurement is to estimate likely lease payments including estimating renewals, contingent rents, purchase options and residual guarantees and record the present value using the lessee's incremental borrowing rate as an asset and a liability. Catch-up adjustments to estimates will be required on reporting dates.
- The favored subsequent accounting is to amortize/depreciate the asset and account for the liability as a loan with imputed interest expense.

Why is the project important?

- Estimates are that US public companies have $1.3 trillion in operating lease payments, which will be capitalized on balance sheet adding assets and liabilities.
- When is a contingent rent a liability and what is the value to be recorded? The idea of estimating and capitalizing contingent rents is a new concept that could significantly increase the capitalized amounts and the complexity.
- What is the nature of the P&L impact of a lease? The P&L impact comparing the current straight line pattern of operating lease accounting versus finance lease accounting could significantly front end lease expense and cause temporary book tax differences, which do not reflect the economic impact of leases. The potential first year increase in lease expense for a 3 year lease is 7% and for a 10 year lease the increased expense is 21%.

- Are some leases in-substance purchases? Failure to recognize in-substance purchases will eliminate sales-type leases, deferring profit recognition for lessors and failing to display the true nature of leased assets on the balance sheet.
- The complexity of lease capitalization, recalculating changes in estimates and deferred tax accounting for small ticket leased assets will be very burdensome.

Who will be impacted?

- All companies lease, with real estate representing about 70% of lease volume.
- Assets such as computers, office, and transportation equipment are leased by almost all companies.
- Banks will be faced with large capital needs from the leased real estate coming on balance sheet and the possibility of front ended lease expense.
- Transportation companies will face significant increases in assets and liabilities and front ended expenses.
- Contingent rent is common for fleet vehicles, copiers and medical equipment and could cause large amounts to be capitalized with no “true” liability.
- Manufacturers will lose the up-front profit recognition when sales-type leases are lost
- Large ticket lessors will lose leveraged lease accounting

What should be done?

Lessees, lessee groups, and manufacturers with captive finance arms 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 real-life business impact of these rules changes. 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) Some leases containing a gross profit are sales and should have a portion of the profit recognized at inception.
4) Leveraged lease accounting reflects the economics of the lease and reduces the lessee’s cost.
5) Certain contingent rents are not liabilities until they are probable to occur.

Lease Accounting Project Interest Groups Issues Grid							
Interest Group	Issue						
	Clarity	P&L Pattern	Contingent Rents	Capital	Complexity	Sales-Type	Leveraged Leases
Users:							
Credit Analysts	x	x			x		
Lenders	x	x			x		
Investors	x	x			x		
Lessors:							
Real Estate		x	x		x		
Equip Mfrs		x	x		x	x	
IT		x			x	x	
Copiers		x	x		x	x	
Medical		x	x		x	x	
Banks							x
Lessees:							
Retail		x	x		x		
Trucking		x	x		x		
Fleet		x	x		x		
Banks		x		x	x		
Airlines		x			x		x
Rail		x			x		x