Armanino McKenna's
ISSUES & INSIGHTS

FASB to Change Accounting for Leases

The lease accounting rules are likely to significantly change in the coming years. Current lease accounting standards have come under criticism for not meeting the needs of users of financial statements. In response, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Boards (IASB) issued a joint discussion paper on March 19, 2009 titled *Leases: Preliminary Views*. The discussion paper was the start of the joint project between the FASB and IASB to create a common standard on lease accounting to promote transparency on the balance sheet in an effort to improve on the understanding of financial reporting. Comment letters were received in July and the Boards have met and deliberated on these issues throughout Fall 2009. The Boards plan to publish an Exposure Draft in 2010. Companies that lease assets from other companies (lessees) and those that own assets being leased to other companies (lessors) need to understand the implications of the proposed changes to lease accounting rules and start planning for the changes once they take effect. The most likely transition rules will require applying the new guidance to leases that are in place as of the effective date, so leases entered into today could fall under these new accounting rules when they become effective.

Current Lease Accounting

Existing lease accounting standards require lessees to classify their lease contracts as either capital leases or operating leases. Capital leases are those leases that transfer to the lessee substantially all the risks and rewards incidental to ownership of the leased asset. All other leases are operating leases. Under a capital lease, the lessee recognizes in its balance sheet the leased asset and an obligation to pay rentals. The lessee depreciates the leased asset and allocates lease payments between a finance charge and a reduction of the outstanding liability. Under an operating lease, the lessee does not recognize the asset or liability associated with the leased asset, but rather recognizes lease payments as an expense. As for lessors, current accounting guidance require that lessors recognize a lease as one of the following: sales type lease, direct financing lease, leveraged lease or operating lease.

Criticisms of Current Lease Accounting Standards

The current lease accounting model has been the subject of criticism for many years. Financial statement users have argued that certain operating leases give rise to assets (the right to use the leased asset) and liabilities (the obligation to pay rentals), thus users have attempted to capitalize the asset when analyzing a company's financial statements and projecting forecasts. Criticism has also been made that the current lease rules are too complex and that the bright line tests are too difficult to apply. As such, similar transactions can be accounted for differently, thus reducing comparability for users. Furthermore, arguments have been made that the existing standards provide opportunities for companies to structure leases so as to achieve a particular lease classification.

The US Securities and Exchange Commission (SEC) recognized that the current lease accounting model is conceptually flawed in its June 2005 Report, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* and recommended that the FASB undertake a project to reconsider the leasing standards, preferably as a joint project with the IASB.

Proposed Changes to Lease Accounting Standards

The proposed changes will eliminate the distinction between capital and operating leases and essentially require lessees to treat all leases as capital leases. The FASB and IASB believe that upon entering a lease contract, a lessee has acquired an asset through its right to use the asset and assumed a liability through its obligation to pay rentals. The new approach would require a lessee to record an asset representing its right to use the leased item for the lease term and a liability for its obligation to make rent payments. As for initial measurement, it was tentatively decided that the lessee would record its right-of-use asset at cost, which would equal the present value of the lease payments discounted at the lessee's incremental borrowing rate. The obligation to make rent payments would be recorded at the present value of the lease payments, discounted at the lessee's incremental borrowing rate.

Regarding changes to lessor accounting, the

© 2009 Armanino McKenna LLP. All Rights Reserved.

FASB and IASB deferred consideration of lessor accounting in the discussion paper, but have been deliberating lessor accounting in subsequent meetings. The Boards have decided to adopt the performance obligation approach to lessor accounting. Under this approach, a lessor would recognize an asset representing its right to receive rental payments and recognize a liability representing its performance obligation under the lease (its obligation to permit the use of its asset). No revenue would be recognized at inception of the lease but would be recognized over the lease term.

Another proposed change is the treatment of options to renew a lease. Current standards only allow consideration of renewal options in the case where renewal is reasonably assured, for instance, when there is a bargain renewal option. The proposed changes would require the lessee and lessor to assume that the lease term includes all renewal options that are more likely than not to be exercised. This will greatly expand the use of renewal options in the calculation of leasing assets and liabilities as well as increase the amount of subjective judgment in deciding what renewal options are more likely than not (greater than 50% chance) to be exercised.

What This All Means

The proposed changes will affect almost all companies since almost all businesses lease assets such as real estate, office equipment, vehicles, etc. Leasing companies that base their business on the leasing of assets to other companies will especially be affected by the changes. Management of all companies need to understand the implications of the rule changes now since it is likely that leases existing at the time the official change in accounting occurs will reflect the new standards and will not be grandfathered in.

Some of the significant implications facing companies if the proposed changes take effect include the following:

- All companies that lease assets will have to capitalize those assets. Balance sheets will be significantly inflated and companies will appear more highly leveraged.
- Lease expense will no longer remain constant through the term of the lease as they were under operating leases. Lease costs will now be higher in the earlier years of the lease and lower in the later years because the lease liability will be amortized using the effective interest method.
- A lessee's compliance with its debt covenants may be impacted.
- A lessee's EBITDA would likely increase since lease expense will be replaced with interest and depreciation expense, both of which are not included in EBITDA. The increase in EBITDA could impact the calculation of certain financial ratios and on bonuses or commissions that are tied to EBITDA.

Companies may have to provide additional training to their accounting department to ensure that the company's lease contracts are being accounted for properly. New policies and procedures may need to be established to ensure there are adequate controls surrounding the accounting for lease transactions.

What Companies Should Be Doing

Most companies have not fully evaluated the impact to their financial statements and operations that will come as a result of the lease accounting changes. Companies need to fully understand the implications of the changes and begin developing a corporate strategy to address the issue. A few considerations to be taken include:

- Buy or lease? If the asset will now be on the balance sheet anyway, companies need to consider whether or not it would be more advantageous to purchase the asset as opposed to leasing the asset. Companies that own that asset will be able to reap the tax benefits of depreciation through the life of the asset, whereas depreciation on a capitalized lease will only run through the lease term.
- Lease terms. Shorter-term leases will likely result in higher rental rates, but will reflect less debt on the balance sheet and overall will have less of an impact on the financial statements. Longer-term leases will likely result in more favorable rental rates, but will increase exposure on the balance sheet.
- Impact to corporate agreements. Companies need to review the ramifications that the change in lease rules will have on corporate agreements such as compliance with debt covenants and bonus and commission agreements tied to EBITDA. Consultation with lenders, legal counsel and accounting advisors is advised to determine if agreements should be amended for changes caused solely by the lease accounting rule change.

Now What?

The discussion paper and subsequent deliberations provide a framework of what's to come, but there are several topics that need to be further discussed and resolved-including subleases, build-to-suits, lease options and the measurement of existing leases. The FASB and IASB have not provided an exact date as to when the new standards will be formally exposed or adopted, but a formal exposure draft is expected in 2010. Companies that invest the time and resources to prepare for the change now will experience a much smoother transition and put themselves in a better position to capitalize not only the leased asset, but also upon the rule changes to make the most financially advantageous transactions. In the ever-changing world of accounting, this is just another change to improve upon financial reporting. At lease we can't say we didn't see this one coming.

Paul O'Grady, Paul Peterson and Grant Lam of Armanino McKenna contributed to this article. Contact them at (925) 790-2600 if you have any questions raegarding this article.

© 2009 Armanino McKenna LLP. All Rights Reserved.