Changes To Lease Accounting: What Should Equipment Manufacturers Know About It?

FASB's Proposed Changes
The Financial Accounting Standards Board (FASB) is a private sector organization funded by corporations—not the government—and overseen by the Securities and Exchange Commission. Its mission is to develop Generally Accepted Accounting Principles (GAAP), which all public companies must follow. As part of the global effort to establish uniform corporate financial accounting standards, the FASB and its sister organization, the International Accounting Standards Board (IASB), are working jointly to develop a new model for the recognition of assets and liabilities arising under lease contracts. The current model, Statement of Financial Accounting Standards No. 13, *Accounting for Leases* (known as FAS 13 and IAS 17), governs the accounting for commercial lease transactions in the U.S. The scope of the new project is the same as FAS 13, covering commercial leases (those related to plant, property and equipment).

The Boards' intent is to capitalize all material leases on lessees' books. This would bring all assets and liabilities on balance sheet and account for the lease contract's rights and obligations as assets and liabilities. The proposed new standard is expected to impact the balance sheets of all companies subject to U.S. GAAP who use leasing to acquire assets or as part of their asset management strategy.

Initially the Project was to address both lessee and lessor accounting and thus replace FAS 13 in its entirety; however, the Project has since been scaled back to address only lessee accounting. This is important because the Boards will take up the issue of lessor accounting at a later time.

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 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 to Businesses?
Estimates are U.S. public companies have $1.3 trillion in operating lease payments which will be capitalized on balance sheets adding assets and liabilities. Sales-type lease accounting reflects economic reality where the lease is a purchase/financing and a gross profit exists. Comparing the current straight-line pattern of lessee

operating lease accounting versus finance lease accounting will significantly front end lease expense and cause book tax differences that do not reflect the economic impact of leases. The first year increase in lease expense for a typical three-year lease is 7 percent and for a 10-year lease it is 21 percent.

When is contingent rent a liability and what is the value to be recorded? Capitalizing contingent rents will significantly increase capitalized amounts and complexity. Lease capitalization, recalculating changes in estimates and deferred tax accounting for leases will be complex and burdensome.

ELFA President Kenneth E. Bentsen, Jr. is concerned about the proposed revisions. ELFA represents the $650 billion equipment finance sector. “The concepts proposed may add more complexity, subjectivity and uncertainty, particularly as it relates to small and medium sized enterprises that are generally not publicly held. If the proposed changes do not reflect an appropriate balancing of costs and benefits, they could result in an unwarranted increase in cost of capital to U.S. companies that utilize leasing as a means of capital formation through the acquisition and investment in capital plant and equipment or real estate. Further, we are disappointed that the Boards decided to split the project and not take up lessor accounting commensurate with lessee accounting,” Bentsen said.

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 present value of the lease rents will be recorded by the lessee as an asset and liability. In a five-year $100,000 equipment lease, the present value rents will be *capitalized at $89,306 or 89 percent of cost* assuming a 7 percent discount rate.

The profit and loss (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 percent and straight line depreciation of the capitalized asset. For a seven-year auto lease with monthly rents of $1,689 and estimated mileage charge of $588, the increase in *first year expense is $2,333 or 11 percent higher than straight line*.

P&L Pattern	YR 1	YR 2	YR 3	YR 4
Current GAAP	21,781	21,781	21,781	21,781
Proposed GAAP	24,114	23,026	21,863	20,618
Difference	(2,333)	(1,245)	(82)	1,163
Difference	-11%	-6%	-	6%
Cum % Diff	-11%	***- 17%***	-	6%

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 and liability and exacerbating the front-ending of expense. The estimates would be reviewed and adjusted at each reporting date with complex calculations and catch-up adjustments to be made. The P&L pattern will not match the IRS tax treatment triggering *deferred tax accounting.*

What Can Businesses Do?
Lessees and lessee groups should become involved in the project by providing comment directly to the FASB/IASB. The discussion paper, *Leases: Preliminary Views,* is available on the 'Open for Comment' section on www.iasb.org [1] and the comment period ends July 17, 2009.

Comments to the Boards could be based on theoretical arguments such as the nature of liabilities, the economics of transactions, the needs of users of financial statements, clarity in financial statements, as well as cost/ benefit and complexity. Specifically, the following points could be emphasized in comment letters:

1. The rights in lease contracts must be considered and 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 faithfully reflects the economics of a true lease
4. Certain contingent rents are not liabilities until they are probable to occur.

William Bosco is a member of the IASB/FASB International Working Group on lease accounting and an accounting policy consultant for the Equipment Leasing and Finance Association (ELFA), the trade association that representing companies in the $650 billion equipment finance sector, which includes financial services companies and manufacturers engaged in financing capital goods. For more information, please visit www.ELFAOnline.org *[2]*

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[1] http://www.iasb.org/
[2] http://www.ELFAOnline.org