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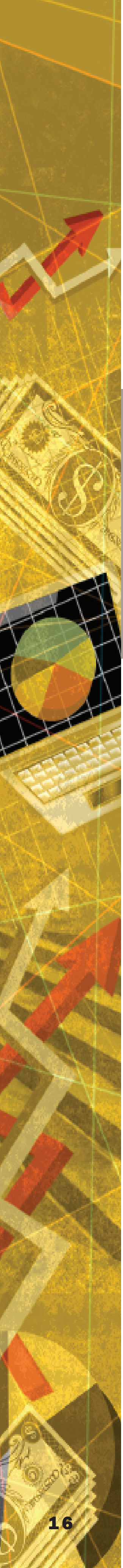

New Views on Lease Accounting

The FASB and the IASB have released a joint discussion paper about leases in which they propose several elements of a new model for lease accounting. For many entities, the proposed changes would increase the complexity of lease accounting and impact key financial ratios.

In the process of creating economic value, business entities typically use a variety of long-lived assets. Frequently, it makes economic sense for an entity to lease—rather than own—the equipment, buildings, and other long-lived assets it uses. Unfortunately, the economic substance of an entity's leasing arrangements often isn't reflected accurately and completely in the entity's financial statements. This situation arises directly from recognized shortcomings of existing accounting standards for leases, such as those found in U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS).

As a step toward improving and converging their existing lease-accounting standards, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently issued a discussion paper titled "Leases: Preliminary Views" in which the Boards jointly propose several elements of a new model for lease accounting. This month's column will explain the key elements of the Boards' proposal and the potential impact of those elements on entities that must account for leases.

What Is a Lease—*Really*?

A lease is a contractual agreement that (1) conveys to the lessee the right to use property legally owned by the lessor and (2) obligates the lessee to compensate the lessor for the use of the property. A lease agreement typically specifies what property is to be leased, the term of the lease, and the payments to be made by the lessee to the lessor.

From a legal perspective, leasing is merely the "rental" of property owned by the lessor. But from an economic perspective, many leases resemble seller-financed purchases of property. This is especially true when a lease agreement contains provisions that effectively transfer the benefits and risks of owning the property from the lessor to the lessee.

In a perfect world, financial statements would faithfully represent the economic substance of relevant transactions and events that affect a reporting entity regardless of the legal form of those transactions and events. But in our imperfect world, substance doesn't always triumph over form.

The potential dichotomy between the legal form of a lease and its economic substance has vexed accounting standards setters for decades. And even when the economic substance and legal form of a lease are consistent with each other, ensuring that financial statements accurately and consistently reflect the economic substance of the lease has proven challenging for standards setters.

How Leases Are Accounted for Today

Currently, both U.S. GAAP and IFRS make a distinction between different types of leases. Under the FASB's Statement of Financial Accounting Standards (SFAS) No. 13, "Accounting for Leases" (see also FASB *Accounting Standards Codification* Topic 840), leases that transfer substantially all of the benefits and risks of ownership from the lessor to the lessee are classified as *capital* leases. International Accounting Standard (IAS) 17, "Leases," refers to such leases as *finance* leases, the term that will be used in the remainder of this article for reasons that will soon become apparent. All other leases are classified under both sets of standards as *operating* leases.

For accounting purposes, finance leases are treated as seller-financed sales of property by lessors to lessees (i.e., "financing" transactions rather than "rental" transactions). In keeping with the assumed economic substance of such leases, lessees are required to recognize (1) the leased property as a depreciable asset and (2) the obligation to make future cash payments (or deliver other economic resources) to the lessor as a liability. Lessors report a receivable asset for amounts due from the lessee, not an asset for the leased property itself, even though the lessor retains legal ownership of the property.

In contrast, an operating lease results in neither an asset nor a liability being recognized by the lessee. The lessor retains the long-lived asset on its balance sheet, depreciating that asset as appropriate.

Potential for Improvement

Existing lease-accounting standards under U.S. GAAP and IFRS are widely considered to have significant potential for improvement. A main area of improvement involves the requirement to classify each lease as "finance" or "operating." Making this distinction as required by existing standards is burdensome on preparers and is of limited usefulness to investors, creditors, securities analysts, and other users of financial statements. Furthermore, the opportunity to classify leases as operating leases is too big a temptation for some lessees, who deliberately misclassify leases as operating leases (or attempt to disguise true seller-financed purchases as operating leases) to avoid recognizing legitimate assets and liabilities on their balance sheets.

Regardless of whether distinguishing between different types of leases is or isn't worth the trouble, there's an even more fundamental area of potential improvement that revolves around how the economic substance of leases in general should be accounted for. The "right" approach might be as finance leases are accounted for today, as operating leases are accounted for today, or an approach not found in today's standards.

The Proposed Approach

In their joint discussion paper on lease accounting, the FASB and the IASB have expressed their preliminary views on several elements of a proposed model for future lease accounting. The key elements of the Boards' proposal are (1) the elimination of the finance/operating lease distinction and (2) a requirement to represent all leases on the lessee's balance sheet through a combination of an asset and a liability.

The rationale for this approach is straightforward and rooted in the similar conceptual frameworks that underlie U.S. GAAP and IFRS. Despite the many special provisions and variations in lease arrangements, the FASB and the IASB view all leases as being similar in economic substance. Specifically, they have concluded that a lessee's right to use leased property meets the definition of an asset, much as other rights that are commonly recognized as assets (patents, franchises, etc.). Similarly, they have concluded that a lessee's obligation to make rental payments to the lessor meets the definition of a liability.

Implications for Reporting Entities

Under the Boards' proposed approach, lessees that currently classify leases as operating leases would certainly recognize more assets and liabilities on their balance sheets than is the case today under either U.S. GAAP or IFRS. Additionally, both lessors and lessees will have far fewer opportunities to structure lease transactions in a manner that enables lessees to keep lease-related assets and liabilities off their balance sheets.

Lessees' financial leverage metrics, such as the liabilities-to-equity ratio, would change, as would measures of lessees' financial performance, such as earnings before interest, taxes, depreciation, and amortization (EBITDA). A widely used, non-GAAP profit measure on which many loan covenants and executive compensation plans are based, EBITDA would increase for lessees that currently recognize rent expense from operating leases. Instead of rent expense, lessees would recognize interest expense, depreciation expense, and expenses for executory costs (insurance, maintenance, etc.). Whereas rent expense is deducted in arriving at EBITDA, interest and depreciation are not.

At the same time, to the extent that interest, depreciation, and executory-cost expenses in total exceed the present rent expense, the lessee's net income would decrease. The reduction in net income, coupled with an increase in lease-related assets on lessees' balance sheets, means that lessees would likely exhibit a lower return on assets (ROA).

There are several other elements of a new model for lease accounting that the FASB and the IASB have proposed in their discussion paper. There are also many questions that the Boards acknowledge must be answered eventually but about which they have formed no preliminary views. In any case, the key elements proposed in the discussion paper would likely impose greater costs on and require greater effort from reporting entities and their auditors. For more details, see the discussion paper at www.fasb.org/draft/DP_Leases.pdf. The public comment period ends July 17, 2009. **SF**

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