

The economic impact of FASB's proposed new lease accounting standard

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ABSTRACT

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly issued exposure drafts on August 17, 2010 proposing a new lease accounting paradigm. The EDs propose changes to simplify lease accounting and improve transparency. The new lease accounting model is based on the core principle that all leases give rise to liabilities for future rental payments and assets---the right to use the underlying asset---that should be reported on the entity's balance sheet. The objective of the new approach is to ensure consistent lease accounting across sectors and industries and thus, to improve the quality and comparability of financial reporting. This paper analyzes the economic impact of the proposed new lease accounting paradigm on the financial statements and derived financial ratios of the reporting entity.

Keywords: leases, Exposure Draft: Leases, FASB Proposed Lease Accounting Standard, IFRS Lease Accounting Standard

INTRODUCTION

Current lease accounting standards categorize leases into two categories: capital leases and operating leases. Capital lease treatment requires recognition of an asset and a liability on lessee books. Operating leases require periodic recognition of rent expense without requiring recognition of the company's future obligation to the lessor. The result creates off-balance-sheet financing in regard to operating leases.

Because U.S. GAAP uses bright-line tests in distinguishing operating and capital leases, lease terms can be structured in a way to achieve a desired reporting outcome with small variations in contract terms. Economically similar transactions may be accounted for in dramatically different ways. Current GAAP through the use of bright-line lease classification criteria allows form to dominate over substance, reducing comparability between entities. Auditors and preparers dislike the complexity of the existing rules-based model.

Due to the off-balance-sheet treatment of operating leases under current GAAP, financial statement users must estimate operating lease effects on financial metrics such as profitability and leverage ratios. Leases often include variable features such as contingent rentals or renewal options that are currently accounted for on an outcome basis if and when they occur. Such an accounting treatment lacks transparency in the assessment of future cash flows related to those variable features.

PROPOSED STANDARD

On August 17, 2010, FASB and IASB jointly issued exposure drafts proposing a new accounting paradigm for leases. The project objective is to provide greater transparency and utility by providing information to users regarding the amounts, timing, and uncertainty of cash flows from lease contracts. The ED proposes to simplify lease accounting standards by establishing one method of accounting by lessees. All leases would require booking an asset and liability, thus bringing operating leases on-balance-sheet, and thus providing more complete and comparable financial reporting. Financial statements would provide users with more accurate information on company liabilities and cash flows. Financial metrics, such as profitability and leverage ratios, would be readily determinable. Elimination of bright-line tests and replacement with principles-based accounting reduces structuring opportunities for lessees and emphasizes substance over form.

NEW MODEL

Core Proposals

The EDs [FASB/IASB, 2010] propose that lessees and lessors account for all leases (within the scope of the proposed standard) by application of a right-of-use model. Assets and liabilities recognized by lessees and lessors would be measured based on the following assumptions:

- the longest possible lease term more likely than not to occur, considering renewal and termination options

- determination of lease payments on an expected outcome basis, considering contingent rental payments, residual value guarantee payments, and expected term option penalty payments
- asset/liability valuations will be reassessed each reporting period to reflect significant changes or circumstances.

The EDs also call for additional disclosures concerning FS balances and the amount, timing, and risk associated with cash flows arising from lease contracts.

Lessees

A right-of-use model is applied under the proposed standard. The lessee has acquired a right to use the underlying asset and pays for this right with lease payments. The lessee would record:

- An asset for its right to use the underlying asset
- A liability to pay future rental payments

The right-of-use asset would originally be recorded at the present value of lease payments and amortized over the lease term as well as tested for impairment. The right-of-use asset would be classified under PPE on the balance sheet, but separated from owned assets [FASB/IASB, 2010]. Table I, located in the Appendix, provides a comparison between current GAAP and the proposed model.

The proposed new right-of-use model [FASB/IASB, 2010] defines the lessee's asset as the right to use the underlying leased asset, an intangible asset, for the lease term. Existing lease accounting rules define the lease asset by the financing method. The right-of-use model is more consistent with FASB's Conceptual Framework definition of an asset, and the reporting consequences are more consistent with FASB's balance sheet approach for financial reporting. Originally, a lessee would record a right-of-use asset at the present value of lease payments. The right-of-use asset will be amortized over the shorter of the lease term or its economic life. Under IFRS, a lessee could revalue right-of-use assets. For balance sheet classification, the right-of-use asset would be classified within the property, plant, and equipment category but separately from owned assets.

The proposed lease liability would be derived using the lessee's incremental borrowing rate as the discount rate or the rate the lessor charges the lessee if that rate can be reliably determined. Current GAAP calls for the lesser of the lessor's implicit rate or the lessee's incremental borrowing rate, if both are known to the lessee or can be imputed. While both current lease accounting standards as well as the proposed new standard determine the present value of future lease payments (excluding executory costs) and consider the lease term and any residual value guarantees, the proposed standard will also consider contingent rentals and expected payments under term option penalties in measuring the lease liability.

Lease payments would be allocated to interest expense and a reduction in the lease liability using the effective interest method. For previously classified operating leases, rent expense, which had previously been recognized under a straight-line method, would be replaced by amortization expense and interest expense. Lease assets and liabilities would be subject to impairment testing each period.

Lessors

Under the proposed guidance, lessors would recognize their right to receive future lease payments as an asset, and depending on risk/benefit exposure, would either (a) recognize a lease liability as well as the underlying asset or (b) derecognize a portion of its rights in the underlying asset (those transferred to the lessee) as well as a residual asset for their rights to the underlying asset at the termination of the lease.

Although FASB and IASB have deferred final consideration of lease accounting for lessors, the new EDs [FASB/IASB, 2010] propose two approaches to reflect the exposure of the lessor to the risks or benefits of the underlying asset:

- the derecognition model
- the performance obligation model

When the lease transfers significant risks or benefits of the underlying asset to the lessee, the lessor should apply the derecognition approach. When the lessor retains exposure to underlying asset risks or benefits, the lessor should apply the performance obligation model. Table II (Appendix) portrays the reporting requirements of each model.

According to the derecognition model, the lessor is required to derecognize (take off the balance sheet) part of the underlying asset and record the right to receive lease payments. Gain recognition at lease inception is possible under this model.

In contrast, the underlying asset remains on lessor books under the performance obligation model. The lessor also records a right to receive lease payments and a liability to the lessee to allow the use of the underlying asset. Lessor income is recognized over the lease term.

ECONOMIC CONSEQUENCES OF THE PROPOSED NEW STANDARD

Leasing is a significant source of financing for many sectors and entities in our economy. According to the *World Leasing Yearbook 2010*, US leasing activity in 2008 totaled \$640 billion. However, many of the resulting assets and liabilities are not reported on lessee balance sheets under current US GAAP. The proposed new lease accounting standard would impose one model for all leases. The result, initially, would be an increase in assets and liabilities on the balance sheet for all leases previously accounted for as operating leases. The income statement would no longer reflect straight-line rent expense, but amortization of the right-of-use asset and interest expense under the effective interest method.

In the early years, lease expenses would exceed lease payments, but in the last half of the lease term this would reverse [Shough, 2011]. Therefore, lease expenses recognized under the proposed standard would be front-end loaded leading to lower net income in the early years of the lease [Eames, 2011]. Financial ratios would be significantly affected, as shown in the lease example in the Exhibits I – V (Appendix).

While total cash outflows do not change under the proposed standard, the classification of the outflows will change. Currently, operating lease rental payments are classified in the cash flow statement as operating outflows. Under the proposed standard, these same outflows will be classified as financing outflows.

SCOPE OF THE PROPOSED STANDARD

The following types of lease contracts are unaffected by the proposed standard:

- Contracts which are actually purchase or sale arrangements, even though labeled leases
- Biological Assets (IAS 41)
- Lessor investment properties marked to market under IAS 40
- Leases of intangible assets such as patents, software, licenses, and leases to explore for/use minerals, oil, natural gas, etc.

A lease contract which is actually representing a purchase transfers control of the asset and all significant risks and benefits to the lessee at the end of the lease term by transferring title or including a bargain purchase option. This determination is made at lease inception.

Short-term leases of 12 months or less would apply simplified accounting procedures in order to mitigate compliance costs. Lessees may elect to recognize lease liabilities at the undiscounted amount of lease payments and right-of-use assets at the undiscounted amount of lease payments plus initial direct costs. These lessees will recognize lease payment expenses in the profit and loss statement over the lease term.

At lease inception, a lessor of a short-term lease may elect not to recognize assets or liabilities arising from a short-term lease in the balance sheet nor derecognize any portion of the underlying asset. The lessor will recognize lease payments over the lease term in the income statement.

PRESENT VALUE OF LEASE PAYMENTS

Determining the Lease Term

The proposed standard defines the lease term as the longest possible term that is more likely than not to occur, considering the effect of any options to extend or terminate the lease. Leases may contain renewal options, early termination penalties, or a combination of a renewal option and a residual value guarantee. For example, at the end of the original lease term, the contract may permit the lessee to return the asset to the lessor or renew the lease for an additional period. If the lessee returns the asset to the lessor, the contract may specify that the lessee pay the lessor the difference between the expected residual value and the actual residual value. At lease inception, the lessee and lessor assess whether it is more likely than not that the option to extend will be exercised. Leases with renewal options, early termination options, or a combination of renewal and residual value guarantees will require the lessee to estimate a probability of occurrence for each possible lease term and calculate the expected outcome to derive the lease term used to discount future lease payments.

This is a subjective process requiring reassessment of the expected outcome more likely than not to occur at each reporting date on the basis of any new facts or circumstances indicating a significant change. The EDs suggest the following considerations in assessing the probability of each possible lease term [FASB, 2010]:

- Contractual factors such as the level of lease payments, bargain renewal options, termination penalties, and contingent rental payments
- Non-contractual factors such local regulations, relocation costs, and significant existing leasehold improvements
- Business factors such as the significance of the underlying asset to the lessee's operations or whether the underlying asset is specialized for the lessee
- Lease-specific factors, such as lessee intentions and past practice.

Lease Payments

Even for lessees who currently account for leases as capital leases, the proposed standard would derive the lease liability by including contingent rental payments, a lease term determined on an expected outcome basis, and option renewal penalties. Therefore, the present value of lease payments calculated under current GAAP vs. the proposed lease model would result in different valuations for the lease asset and liability on the statement of financial position for lessees.

Lease payments are determined on an expected outcome basis. According to the EDs [FASB/IASB, 2010], estimating expected outcomes requires:

- Identifying each reasonably possible outcome
- For each reasonably possible outcome, estimate the amount and timing of the cash flows
- Calculate the present value of the cash flows
- Estimate the probability of each outcome

A lessee will determine the present value of lease payments during the lease term on the basis of expected outcome. The expected outcome is the present value of the probability-weighted mean of the cash flows for the reasonably possible outcomes. In measuring present value, the lessee should include:

- Contingent rental payments
- Estimated future payments under residual value guarantees
- Estimated expected payments under term option penalties.

Lessees would always include contingent rentals but lessors would only include contingent rentals that they can measure reliably.

COST BENEFIT ANALYSIS

FASB's Conceptual Framework states the primary objective of financial reporting is to provide information useful to investors and creditors for decision making. The qualities necessary to insure decision utility are relevance and reliability. Based on FASB's outreach efforts and the comment letters received, the majority of users believe the proposed model to be an improvement over existing lease accounting rules. During the development of the proposed standard, the boards obtained feedback from the International Working Group on Lease Accounting, users and preparers of financial statements, regulators, auditors, and from a wide range of industries and diverse geographical locations. Proponents cited an increase in accuracy, greater representational faithfulness, and enhanced comparability between entities as significant improvements. Particular improvements include [IFRS, 2011]:

- Users would no longer have to make adjustments to operating lease information or rely on adjustments made by analysts using estimates or other subjective judgments.
- Due to inclusion in lessee assets and liabilities of the effects of contingent features and amounts payable in optional periods, users benefit from better information concerning expected cash flows. Under current GAAP, analysts often had difficulty determining lease terms and the expected lease payments.

Some preparers expressed concern about:

- The significant administrative cost for an entity with a large volume of small leases with different terms. Determining an appropriate discount rate for each lease contract and measuring the liability on an amortized cost basis would strain limited resources.

- On a lease-by-lease or store-by-store basis, the cost of reassessing contingent rentals and extension/termination options at each reporting date for entities with a large lease volume would be significant and might not provide significantly more useful information.
- A new model would not add benefit to business operations, but result in significant costs due to compliance and implementation costs.

The boards evaluated costs and benefits of the proposed standard considering the following:

- Costs to reporting entities to implement the new model
- Costs incurred by users when needed information is not available in the financial statements and users must obtain it on their own or from other sources, which are often based on estimates and more subjective---less reliable.
- The comparative cost advantage of reporting entities over users in developing needed information which, if not provided in the financial statements, users must develop proxies for.

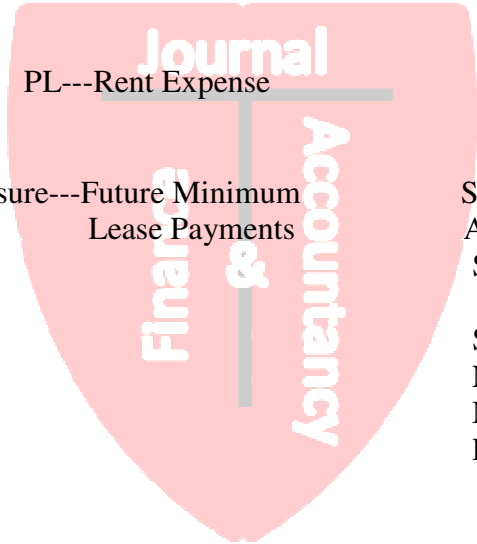
To attain greater decision-utility the boards endeavored to address problems in existing rule-based guidance. Though implementation costs of the proposed model will not be borne evenly, financial statement users benefit from improved financial reporting. This facilitates capital market efficiency.



APPENDIX

TABLE I
A Comparison of Current GAAP & the Proposed Standard [IFRS, 2011]

	Reporting	Utility
Current GAAP---2 Different Types of Leases		
Capital (Finance) Lease	BS--- Asset & Liability Recorded PL---Depreciation Expense Interest Expense Disclosure---Future Minimum Lease Payments	Investors & Creditors use FS Info for Decision Making and Analysis (Ratios)
Operating Lease	BS---No Asset or Liability Recorded PL---Rent Expense Disclosure---Future Minimum Lease Payments	Investors & Creditors Must Adjust FS Info To Reflect all Assets, Liabilities & Finance Costs arising from Operating Leases Such Adjustments may be Arbitrary or Based on Subjective Estimates Such Adjustments are also Necessary before Financial Metrics such as Financial Ratios are Calculated



Proposed Standard

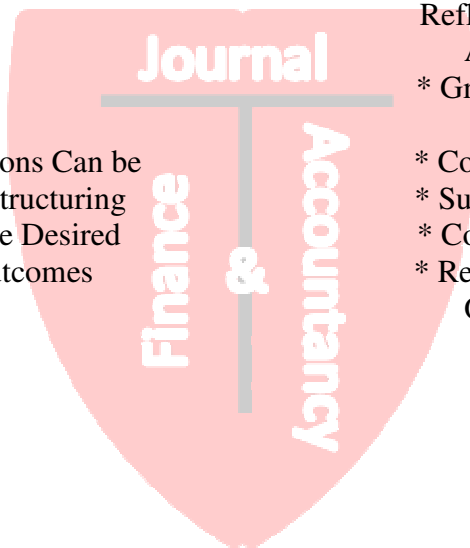
<p>One Model for all Leases</p>	<p>BS---Right-of-use Asset Liability for future Lease payments</p> <p>PL---Amortization Expense Interest Expense</p> <p>Disclosure---Explain Amounts Recognized in FS and Cash Flow Effects</p>	<p>Investors & Creditors have More Complete Info in FS On All Assets and Liabilities Resulting from Leasing as Well as Expected Cash Flows for all Leases</p>
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Problems Under Current GAAP

Proposed Solution

* Understatement of Assets & Liabilities
For Operating Leases

* Similar Economic Transactions Can be
Accounted for Differently---Structuring
Opportunities Exist to Achieve Desired
Accounting and Reporting Outcomes



* New Lease Accounting Model
Reflects all Lease Contract
Assets & Liabilities
* Greater Transparency

* Consistent Lease Accounting
* Substance Over Form
* Comparability Enhanced
* Reduced Structuring
Opportunities

TABLE II

*Transfer of Significant Risks/Benefits of Underlying Asset to Lessee?

Yes		No	
<u>Derecognition</u>		<u>Performance Obligation</u>	
	<u>Balance Sheet</u>		
Residual Asset	\$	Underlying Asset	\$
Right to receive lease Payments	\$	Right to receive lease payments	\$
		Lease Liability	(\$)
		Net Lease Asset/ (Liability)	\$
	<u>Income Statement</u>		
Revenue	\$	Lease Income	\$
Cost of Sales	(\$)	Depreciation Expense	(\$)
Interest Income	\$	Interest Income	\$

*[IFRS, 2011]

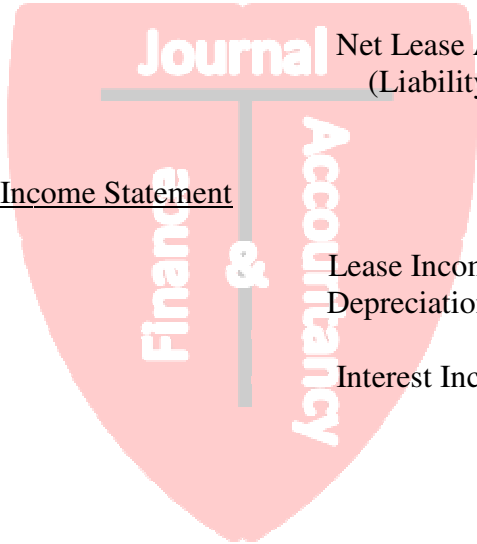


EXHIBIT I

EXAMPLE: IMPACT OF PROPOSED NEW LESSEE ACCOUNTING MODEL

Annual Lease Payments \$10,000(EOY) Lease term: 4 years
 (No residual guarantees,
 contingent rentals, option
 penalties, executory costs)
 Lessee's incremental borrowing rate: 6%

Right-of-use Asset \$34,651
 Lease Liability (PV of lease payments) \$34,651

Lease Inception: Jan. 1, Year 1

Journal Entries:

1/01/Y1

Right-of-use Asset \$34,651
 Lease Liability

12/31/Y1

Interest Expense 2,079
 Lease Liability 7,921
 Cash

Amortization Expense 8663
 Right-of-use Asset 8663

12/31/Y2

Interest Expense 1,604
 Lease Liability 8,396
 Cash

Amortization Expense 8,663
 Right-of-use Asset 8,663

12/31/Y3

Interest Expense 1,100
 Lease Liability 8,900
 Cash 10,000

Amortization Expense 8,663
 Right-of-use Asset 8,663

12/31/Y4

Interest Expense 566
 Lease Liability 9,434
 Cash 10,000

Amortization Expense 8,662*
 Right-of-use Asset 8,662*
 *(Rounding)

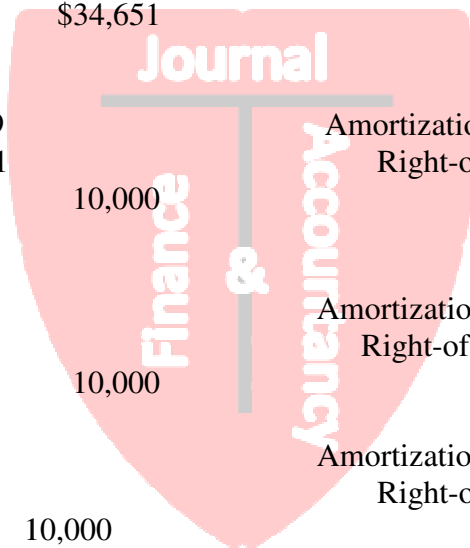


EXHIBIT II
INCOME STATEMENT EFFECTS

	<u>Proposed Model</u>			<u>Operating Lease</u>
	<u>Expense</u>			
	<u>Amortization</u>	<u>Interest</u>	<u>Total</u>	<u>Rent</u>
Y1	8,663	2,079	10,742	10,000
Y2	8,663	1,604	10,267	10,000
Y3	8,663	1,100	9,763	10,000
Y4	8,662	566	9,228	10,000
	Totals		40,000	40,000

EXHIBIT III
BALANCE SHEET EFFECTS

	<u>Proposed Model</u>		<u>Operating Lease</u>
	<u>Assets</u>	<u>Liabilities</u>	No Balance Sheet Impact
BOY1	\$34,651	\$34,651	No Asset/Liability
EOY1	25,988	26,730	Recorded
EOY2	17,325	18,334	
EOY3	8,662	9,434	
EOY4	0	0	

EXHIBIT IV
CASH FLOW EFFECTS

	<u>Proposed Model</u>	<u>Operating Lease</u>
Y1	10,000	10,000
Y2	10,000	10,000
Y3	10,000	10,000
Y4	10,000	10,000
	Totals	40,000

EXHIBIT V
*FINANCIAL RATIO IMPACT FOR LESSEES

<u>Ratio</u>	<u>Expected Change under Proposed Model</u>	
<u>Liquidity Ratios:</u>		
<ul style="list-style-type: none"> • Current Ratio (Based on Current Portion of Lease Liability) 	Decrease	↓
<u>Leverage Ratios:</u>		
<ul style="list-style-type: none"> • Debt to Equity Ratio (Total Debt increases; Total Equity decreases) 	Increase	↑
<ul style="list-style-type: none"> • Debt Ratio (Assets and Liabilities increase by same amount) (Assuming Total Debt < Total Assets) 	Increase	↑
<ul style="list-style-type: none"> • Times Interest Earned Ratio (EBIT decreases; interest expense increases) 	Decrease	↓
<u>Efficiency Ratios:</u>		
<ul style="list-style-type: none"> • Asset Turnover (Increase in Total Assets; no change in net sales) 	Decrease	↓
<u>Profitability Ratios:</u>		
<ul style="list-style-type: none"> • ROA (Decrease in NI; Increase in Total Assets) 	Decrease	↓
<ul style="list-style-type: none"> • ROE (Assumes equal decrease in NI and Equity) 	Decrease	↓
<ul style="list-style-type: none"> Profit Margin (Decrease in NI; no change in net sales) 	Decrease	↓

*Financial Ratio Impact for Lessors has been deferred until FASB/IASB final guidance for lessors is issued.

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