Lease accounting
Enhancing the financial reporting model

Striking the right balance

• The FASB and IASB (the Boards) have proposed that substantially all leases be reported on a company’s balance sheet. In the income statement, the results of lease transactions would be recognized under a dual model—as either a financing (i.e., expense would be front-loaded) or ratably over the lease term (i.e., straight line expense). The recognition pattern generally would depend on whether the asset being leased is property (e.g., a building) or non-property (e.g., equipment).

• Stakeholders benefit from financial statements that reflect the economics of a transaction. As such, we support the principle that a company should recognize the right to use an asset along with the contractual liability on its balance sheet. And, since not all leases are economically similar, we support a dual model for income statement recognition. However, we do not support an income statement recognition pattern based on the nature of the leased asset because such an approach does not necessarily reflect the economics of the lease.

• We support an alternative income statement recognition pattern that is based on whether the lease, in effect, transfers the risks and rewards of ownership such that the company that is leasing the asset has, in substance, purchased the asset. Our alternative eliminates the quantitative bright-lines in existing US lease accounting standards, is familiar to those accustomed to the international lease accounting standards, better reflects the economics of the arrangement, and provides more transparency to users of financial statements.

Highlights

• Many companies enter into lease transactions, as they allow for the use of property and equipment with payments made over time.

• The Boards’ proposals require leases to be reported on the balance sheet. The income statement impact would depend on the nature of the leased asset under one of two models.

• We applaud the Boards’ for their efforts to provide greater transparency into a company’s leverage and the assets employed in the business.

• We do not believe the proposed income statement approach will best reflect the economics of transactions.

• We recommend an alternative approach – based on indicators of effective ownership – to determine income statement recognition.
The call for change

The importance of leasing
Many companies use leases as an alternative to purchasing assets. Leases enable companies to use property, plant, and equipment without making large initial cash outlays. They also provide flexibility, enabling companies to address obsolescence risks. Sometimes leasing is the only way to obtain the right to use an asset that is not available for purchase.

Rationale for an accounting change
Current rules do not promote a financial statement user’s ability to compare the financial position and operating results of companies that buy assets with the financial position and operating results of companies that lease similar assets. Not surprisingly, this has led critics to assert that the current accounting does not portray the economics of lease arrangements.

Many financial statement stakeholders want an accounting model under which future lease commitments are reported on a company’s balance sheet.

The proposed models
The Boards are proposing that companies recognize assets and liabilities arising from a lease.

The user of a leased asset would recognize an asset (representing the right to use the leased asset) and a liability (representing the obligation to pay rent) at the beginning of a lease. Thereafter, the asset would be reduced by amortizing it (similar to depreciation) over the term of the lease. The liability would be reduced as periodic rent payments are made.

The expense recognition pattern in the income statement would depend upon the nature of the leased asset. Unless certain indicators are met, leases of property, such as land and buildings, would result in a straight-line expense recognition pattern. Leases of non-property, such as equipment, will generally result in front-loaded expense. That is, instead of rent expense, the income statement will report interest expense on the lease liability and amortization expense resulting from amortization of the leased asset.

The accounting by a supplier of the leased asset would also depend on the nature of the leased asset. Leases of property would generally result in a straight-line income recognition pattern in the income statement. Leases of non-property, such as equipment, would generally result in front-loaded income recognition.

What’s next
In May 2013, the Boards issued their proposals inviting comments from stakeholders. The comment period ended September 13, 2013. The Boards now begin the task of analyzing the comments received to determine next steps.

The proposals will affect almost every company and the impact of the proposed changes may be significant. The Boards will take those factors into consideration when determining the effective date of any new standard.

The existing accounting model does not promote comparability of the financial position of companies that buy assets with those that lease similar assets.

The Boards’ lease proposals aim to provide greater transparency and comparability for financial statement users.
The benefits of a "risks and rewards" model

The proposed income statement model introduces a bias

Since the economic characteristics of leases differ, we agree that having different income statement recognition models is appropriate. However, under the proposal determining whether the amount reported in the income statement should be straight-lined (property) or front-loaded (equipment) introduces a bias for one approach or the other based solely on the nature of the underlying asset, which may not reflect the economics of the transaction.

For example, assets such as aircraft, rail cars, and ships generally have economic lives comparable to property and the leases of these types of equipment are often priced in a manner similar to property leases. However, under the proposals the accounting for leases of most of these assets will result in an income statement impact that is front-loaded. This is in contrast to the straight-line result for a lease of property with similar terms.

A risks and rewards based alternative approach

We believe the concepts in the current "risks and rewards" model in international lease accounting standards are a more appropriate basis to determine the income statement recognition method used.

Under those standards a determination is made of whether a lease transfers substantially all the risks and rewards associated with ownership of the leased asset to the user, without the quantitative bright-lines that are in the US lease accounting standards. Qualitative criteria considered include:

- Ownership is transferred by the end of the lease term; or
- The user has a purchase option at a price sufficiently below fair value such that the user is expected to exercise it; or
- The lease term is for the major part of the economic life of the asset; or
- The present value of the lease payments is equal to substantially all of the fair value of the asset; or
- The assets are so specialized that only the user can use them without major modifications.

Other indicators that individually or in combination could also indicate that risks and rewards of ownership are transferred to the user of the leased asset are as follows:

- The user must bear the cost of any losses incurred by the lessor that are caused by the user cancelling the lease;
- The user benefits or is impacted by gains or losses from fluctuation in the fair value of the leased asset;
- The user has the ability to renew the lease at rates that are below market.

If, based on the qualitative criteria, the risks and rewards of ownership are transferred to the user of the leased asset, the transaction would be reported in the financial statements as a financing, similar to an asset purchase, with income statement recognition front-loaded. If not, then the income statement would reflect an amount ratably over the lease term.

In conclusion

We applaud the Boards for pursuing an objective of enhancing lease accounting by providing a model that promotes more transparency for users of financial statements. However, we believe that income statement recognition should depend on whether the lease, in effect, transfers the risks and rewards of ownership such that the user has, in substance, purchased the asset. This approach would remove the quantitative bright-lines in existing US lease accounting standards, be familiar to certain stakeholders, and best reflect the economics of the transaction, thereby enhancing the quality of financial reporting.
Questions and answers

Q: What is the proposed process for transitioning to this new guidance?
A: Two methods have been proposed. One method is effectively a shortcut method based on an approximation; the other method involves applying the proposed guidance from the lease start date. There is no grandfathering and companies will need to effectively “re-state” existing affected leases as of the beginning of the earliest comparative period presented in the financial statements.

Q: If substantially all leases would be reported on the balance sheet, what leases would not be?
A: A company could elect, as an accounting policy, not to report short-term leases on the balance sheet. A lease would be considered short-term if the base lease term plus all extension options equals 12 months or less.

Q: Given the new standard may be several years away, what should companies be thinking about today?
A: Bringing substantially all leases onto the balance sheet and the proposed changes to income statement recognition may have far reaching impacts. Companies will want to understand the extent to which their organization uses leases and the nature of those leases. Ultimately a new standard may impact how they make strategic decisions about whether to lease or buy property and equipment. Companies should use the time now—well before the date they will have to apply a final standard—to take a measured approach to addressing the standard’s potential impact. They may want to start by assessing what changes would be needed to their systems and processes to enable them to gather information to satisfy the new requirements. Such an assessment might consider how long it would take to design and implement such changes.

Once a final standard is issued, communication may be needed with investors, lenders, regulators, rating agencies, and others to explain its impact. Companies may also need to renegotiate certain contracts, such as debt agreements, to address the impact on debt covenants of reporting lease liabilities on the balance sheet. They may also want to renegotiate compensation plans that are based on financial metrics, as those metrics may change under the proposed models.

Since the impacts may ripple through the business, companies will want to determine which business units need to be aware of the potential changes and educate the key business leaders of those units. In addition to a company’s information technology group, support may be needed from various other groups within an organization including human resources, tax, procurement, treasury, and investor relations.

Q: How would the proposed model affect private companies?
A: The proposal would have a significant impact on all companies, including private companies. However, private companies would be provided some relief in measuring the lease liability and would be required to make fewer disclosures. The Private Company Council has not yet formally reacted to the FASB’s proposal. However, they provided input to the FASB and will continue to do so throughout the Boards’ redeliberation process.