point of view

The future of leasing

Standard setters plan to require all leases to be reported on balance sheet. The impact on lessee financial reporting, equipment financing, IT, systems, and controls could be substantial.

Highlights

- Balance sheets would be expanded by the addition of leased assets and related obligations
- Lease obligations would be greater than we see reported today under current lease accounting treatment
- Lease obligations would require ongoing re-measurement
- Existing operating leases would not be grandfathered
- Lessor accounting still under discussion

What would the change mean for companies that lease assets?

- Although a final standard is not imminent, standard setters appear ready to require all leases, not just capital leases, to appear on the balance sheet.
- Companies leasing "big-ticket" items, including real estate, manufacturing equipment, aircraft, railcars, ships, computers and technology would be greatly impacted. Companies with numerous small leases, such as office equipment and auto fleets, would also be affected.
- Balance sheets would grow, leverage ratios would increase, and capital ratios would decrease.
- Performance and cash flow measures such as EBIT and EBITDA would change.
- "Lease–buy" decisions may be affected.

A structure is emerging for a single, comparable, worldwide leasing standard

The new lessee accounting model would put more assets and liabilities on balance sheets and would require more effort to gather and evaluate the necessary information.

Leasing is an important and widely used financing tool. It enables companies from start-ups to multinationals to acquire the right to use property, plant, and equipment without making large initial cash outlays.

Companies currently account for leases as either operating leases or capital leases. Lease classification is based on complex rules and "bright-line" tests. Though an operating lease may provide nearly the same risks and rewards as outright ownership, the leased asset is not currently recorded on the balance sheet. Rather, rent expense is recorded throughout the lease term.

Many companies use operating leases, in part, because the leased assets and related liabilities are not recognized on their balance sheets. Some investors believe this makes it difficult to compare the financial positions and operating results of companies that buy assets versus those that lease equivalent assets. For these reasons, among others, lease accounting rules have been criticized for not portraying the economics of everyday lease arrangements.

As part of its global convergence process, standard setters ("the Boards") have been working to create a single, comparable, worldwide leasing standard. In March 2009, they outlined their preliminary ideas in a joint discussion paper. (PwC DataLines 2009-14 and 2009-42 contain a more in-depth analysis of the discussion paper.)

While deliberations are ongoing, the standard setters have generally agreed that all leased assets should appear on balance sheets. Some details have yet to be determined, but the model outlined in the discussion paper addresses many criticisms of current lessee accounting and appears to have solid standard-setter support. Companies therefore should start analyzing and anticipating the potential impact of all leased assets being reflected on their balance sheets.

The proposed model

The discussion paper proposes that companies recognize an asset and liability at the beginning of a lease. Thereafter, the asset would be depreciated or amortized over its expected life. Periodic rental payments would be recorded as payments of principal and interest on the related lease liability.

This approach may present challenges to some companies, as it would require making estimates of the expected lease term and contingent payments. It would require gathering more information and making more judgments.

Lease term

Many leases include renewal options. Under the proposed model, a company would measure the leased asset and related liability based on a "most likely" lease term. This would require companies to evaluate the likelihood of exercising renewal options on every lease. Companies would re-measure and update the estimates at each reporting date.

Contingent payments

Some leases include contingent rents or other contingent payments. These amounts, which would have to be estimated, would be included when determining the value of the leased asset and related liability at the beginning of the lease. They would also be reassessed at each reporting period.

The measurement details of lease term and variable cash flows are still under discussion. But this much is clear: the new lessee accounting model would put more assets and liabilities on balance sheets and would require more effort to gather and evaluate the necessary information.

Balance sheets would grow, leverage ratios would increase, and capital ratios would decrease

The new model as proposed would change both balance sheet and income statement presentations.

These changes may affect loan covenants, credit ratings, and other external measures of financial strength derived from financial statement metrics.

Business implications

The proposed model would affect financial ratios and metrics, lease-versus-buy decisions, information needs, and systems and controls. As such, companies may want to begin thinking about potential business implications now, well before a final standard is issued.

Financial ratios and metrics

The proposed model would change both balance sheet and income statement presentations. Balance sheets would expand from recording leased assets and related obligations. Leverage and capital ratios may suffer as a result.

Rent expense would be replaced in the income statement by depreciation or amortization and interest expense. Moreover, interest expense under the effective yield method would be higher in a lease's early years compared to the current straight-line treatment for rent expense. Rent expense recast as interest expense would improve performance measures, such as EBIT and EBITDA, without changing underlying cash flows.

These changes may affect loan covenants, credit ratings, and other external measures of financial strength derived from financial statement metrics. Internal measurements used for budgeting, incentive and compensation plans, and other financial decisions may be similarly affected.

Companies should evaluate the potential impact of these items on their financial positions and results. It may be necessary to amend affected agreements and inform analysts, bankers, rating agencies, and other users of the company's financial data of expected changes as the proposed model moves toward implementation.

Lease-buy decisions

The proposed model may change how companies negotiate future leases or affect "lease-buy" decisions as the appeal of leases may diminish. Accordingly, other financing options might be considered when new leases are contemplated, even if they would commence prior to the potential standard's ultimate effective date.

Information needs

The proposed model currently does not include grandfathering for existing leases. Unless that changes, companies would need to catalog existing leases and gather data about lease term, renewal options, and payments to measure the amounts to be included on their balance sheets. Depending on the number of leases, the inception dates, and the records available, gathering and analyzing the information could take considerable time and effort. Beginning the process early would ensure that implementation of a future standard is orderly and well controlled.

Systems and controls

Historically, many companies have not needed robust systems and controls for leases. A process was needed to initially classify a lease as operating or capital but, once classified, existing accounts payable or fixed asset systems generally sufficed. To apply the proposed model, companies may need to invest in information systems that capture and catalog relevant information and support reassessing lease terms and payment estimates at each reporting period. Companies should plan to evaluate their systems and controls to ensure they have the appropriate infrastructure in place should the new model become effective.

Additional reporting burden

Reassessing lease terms and payment estimates at each reporting date would require more ongoing effort than current accounting, which is set at inception and revisited only when the lease is modified or extended. Monitoring and evaluating estimates and updating recorded balances may require additional resources. Companies should plan accordingly should the new model be adopted.

Companies should evaluate the implications of the new model

Q&A

Q: Are you suggesting that we may need to develop an entirely new system to track leases?

A: Many companies manage operating leases either on spreadsheets or through their accounts payable system. The information needed to reassess expected lease terms and payments at each reporting date would require extensive data capture. The information and systems needs of companies vary, but we expect most companies may need to modify their information systems, processes, and internal controls to comply with the proposed lessee accounting model.

Q: Why did the Boards tentatively determine that grandfathering of existing leases would not be allowed?

A: If all leases had a one- to two-year lease term, there would only be a short period of noncomparability. Some leases would be accounted for under the prior rules and some under the proposed rules. However, because many leases are for much longer terms, grandfathering existing leases would create, in the view of standard setters, an unacceptably long period of noncomparability.

Q: We have a lease that was entered into long ago. What if we can't find the lease records?

A: The Boards recognize that companies may not have some lease documents available when the standard becomes effective. Subsequent to the issuance of the discussion paper, the Boards briefly discussed the method of transition. While details remain to be worked out, they recognize that practical transition guidance may be necessary.

Q: We don't have many "big-ticket item" leases. How would the proposal affect us?

A: Though the proposed model would have a bigger impact on industries that lease large equipment and real estate (such as in aerospace, healthcare and retail), it would apply to all leases regardless of size (very short-term leases may be ultimately exempted). Moreover, businesses without many big-ticket leases may have large numbers of small leases, such as for computers, copiers, printers or other office equipment. The impact of the proposed model on large numbers of small leases could still be significant. As a result, we expect all companies would need to evaluate the business, financial, systems and controls implications of the suggested model.

Q: Does the proposed model affect lessors?

A: Lessors may be affected if more companies decide to finance their asset purchases through leasing alternatives. Lessors therefore may want to study the effects lessee changes would have on their customers and overall businesses. In addition, the Boards plan to address lessor accounting at a later date.

Contact information

To have a deeper discussion about how the new lessee accounting model might affect your business, please contact:

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