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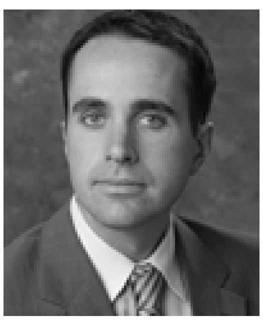
LEASES

Looming Lease Accounting Changes: What Will the Final Rules Look Like?



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Final rules that will dramatically change current lease accounting rules are scheduled to be issued this summer. The new rules could have a significant impact on both the debt reported on a company's balance sheet and its earnings before interest, tax, depreciation, and amortization (EBITDA). In general, the change will affect all companies that lease assets (e.g., real estate or equipment), regardless of the type or value of such assets. The new lease accounting standards will also affect commercial, financial and employment related plans and agreements that use financial ratios or EBITDA measurements, including debt agreements, compensation agreements and earnout agreements. This article discusses the background of the lease accounting rule changes, the reasons for the changes, an update of the decisions to date regarding the new rules and the implications and likely timeline for implementation of the standards. Although the pro-

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 ISSN 1558-6642

posed new rules deal with both lease accounting by lessees and lease accounting by lessor, this article focuses on the accounting by lessees, as those changes are likely to have the greatest impact.

Background. Recognizing the inadequacies of existing lease accounting standards, the U.S. Securities and Exchange Commission's (SEC) report on off-balance sheet arrangements and special purpose entities issued pursuant to the Sarbanes-Oxley Act of 2002 recommended that the Financial Accounting Standards Board (FASB) undertake a project to reconsider lease accounting standards. On March 19, 2009, the FASB and the International Accounting Standards Board (IASB, and referred to with the FASB as the Boards) issued a joint discussion paper on accounting for leases by lessees. The Boards' joint project on lease accounting is part of the 2006 Memorandum of Understanding between the Boards that set forth the Boards' mutual agreement to converge accounting standards. Among other changes, the proposal in the discussion paper would require that all leases be treated by lessees as capital leases, requiring lessees to include an asset and liability related to the leased asset on their respective balance sheets. On August 17, 2010, the Boards published an Exposure Draft for public comment. In December 2010 and January 2011, the Boards held public roundtable meetings to discuss the Exposure Draft with a wide variety of stakeholders, including preparers, auditors, investors and other users of financial statements. Throughout the process, the Boards have continued to refine the proposed rules, as further discussed later in the article.

Current Standards for Lessees Under U.S. GAAP Existing lease accounting standards require lessees to classify their lease contracts as either capital leases or operating leases. Capital leases are defined as leases that transfer substantially all of the risks and rewards incidental to ownership of the leased asset to the lessee. All other leases are classified as operating leases. Since capital leases are viewed as similar in substance to a purchase of the underlying asset, the lessee recognizes an asset for the leased asset and a corresponding liability for the obligation to make the lease payments. The lessee depreciates the leased asset and apportions the lease payment between interest expense and a reduction of the lease liability. Alternatively, if the lease is accounted for as an operating lease, no asset or liability is recognized on the balance sheet. Rather, the lessee recognizes lease payments under an operating lease as an expense, normally on a straight-line basis over the lease term. In order to avoid recognizing the obligation to make payments under a lease, many lessees attempt to structure lease transactions so that operating lease treatment will be permitted.

Criticisms of the Existing Lease Standards. Existing lease accounting standards have been the source of debate for many years. Many financial statement users believe that the distinction between capital leases and operating leases is an artificial one and that operating leases, like capital leases, give rise to assets and liabilities that should be recognized on a lessee's balance sheet. In fact, many financial analysts ignore the distinction and attempt to capitalize a company's operating leases when making projections or analyzing the company's balance sheet. Other criticisms of current lease accounting rules include:

- The difficulty experienced by issuers and auditors in drawing the line between operating and capital leases in a principled way, given the mixture of subjective judgments and ''bright-line'' tests;
- The opportunity to structure transactions to achieve a particular lease classification;
- The lack of comparability when one company classifies its leases as operating leases and another company classifies similar leases as capital leases; and
- The lack of sufficient footnote disclosure relating to operating leases necessary to make adjustments to recognized amounts for leased assets and liabilities.

Critics also point out that current lease accounting standards are conceptually flawed. In particular, upon entering into a lease, the lessee assumes a valuable right (the right to use the leased item). This right to use the leased item meets the Boards' definitions of an asset. Similarly, the lessee incurs a payment obligation that meets the Boards' definitions of a liability. However, if a lease is accounted for as an operating lease, these assets and liabilities are not recognized.

Proposed Changes Set Forth in the Discussion Paper. The proposal presented in the discussion paper would essentially require lessees to treat all leases as capital leases, using a method the Boards refer to as the ''right to use method.'' The Boards believe that the right to use a leased asset is an asset and the obligation to make lease payments is a liability. Accordingly, these assets and liabilities must be included on a lessee's balance sheet to faithfully represent the substance of the lease transaction.

The Boards proposed in the discussion paper that the asset and liability should be recorded at the lessee's cost. The cost of the leased asset would be determined by calculating the present value of the lease payments discounted using the lessee's incremental borrowing rate. In the discussion paper, the Boards stated that they decided against using the lease's implicit rate because it is often difficult for the lessee to determine. The discussion paper also presents proposals for several other matters relating to lease accounting, including subsequent measurements and leases with uncertain terms or options, while many other details were left open. Since issuing the discussion paper, the Boards have reconsidered a number of their decisions and have also addressed many of the details that were left open at the time of the discussion paper. Although there have been some changes to the proposals in the discussion paper, the fundamental concept of the rule change has remained the same.

Decisions Reached Since the Issuance of the Paper. The proposals in the discussion paper have been refined based on the comment letters and other input received from financial statement users as a result of the Boards' outreach activities.

  APPR ISSN 1558-6642

For companies with significant leases, . . . the time to get ready is now.

The following is a summary of a number of the key decisions reached by the Boards and expected to be included in the final rules (although many of the decisions are still tentative at this point):

■ *Lease Term.* The lease term will be defined as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for the lessee to exercise an option to extend the lease, or for the lessee not to exercise an option to terminate the lease. Lessees will be required to reassess the lease term only when there is a significant change in relevant factors such that the lessee would then either have, or no longer have, a significant economic incentive to exercise any options to extend or terminate the lease.

■ *Inception Versus Commencement.* Lessees will be required to recognize and initially measure lease assets and lease liabilities at the date of the commencement of the lease (i.e., when possession is granted). The final standards will include application guidance on the accounting for costs incurred by the lessee (including any lease payments made) after the inception (i.e., signing) of the lease and before the date of commencement of the lease.

■ *Variable Lease Payments.* Variable lease payments include any lease payments that arise under the contractual terms of a lease because of a change in facts or circumstances occurring after the date of inception of the lease, other than the passage of time. The lessee's liability will include (a) lease payments that depend on a rate or index; (b) lease payments for which the variability lacks commercial substance; and (c) lease payments that meet a high recognition threshold (such as reasonably certain). Variable lease payments that depend on an index or rate will be measured initially based on the spot rate.

■ *Purchase Options.* The exercise price of a purchase option (including bargain purchase options) will be included in the measurement of the lessee's liability to make lease payments if the lessee has a significant economic incentive to exercise the purchase option. If the exercise price is included, then the right-to-use asset recognized by the lessee must be accounted for over the economic life of the asset, rather than over the lease term.

■ *Short-Term Leases.* A lease that, at the date of commencement of the lease, has a maximum potential term, including options to renew of 12 months or less is considered a short-term lease. Lessees may elect, as an accounting policy for a class of underlying assets, to account for all short-term leases by not recognizing lease assets or lease liabilities and by recognizing lease payments in profit or loss on a straight-line basis over the lease term, or using another systematic and rational basis if it is more representative of the time pattern in which use is derived from the underlying asset.

■ *Residual Value Guarantees.* Lease payments will include amounts expected to be payable under residual value guarantees, except for any amounts payable under guarantees provided by an unrelated third party.

■ *Initial Direct Costs.* Lessees will be required to capitalize initial direct costs by adding them to the carrying amount of the right to use asset. Initial direct costs will be defined as ''costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.''

■ *Discount Rate.* Lessees will use the rate the lessor charges in the lease (i.e., the implicit rate) when that rate is available. Otherwise, a lessee will use its incremental borrowing rate.

■ *Separating Lease and Non-lease Components of a Contract.* Lessees will be required to identify and separately account for the lease and the non-lease components of a contract. In allocating payments in a contract between the lease and non-lease components, lessees will be required to allocate the payments based on the purchase price of each component, or if the purchase prices are not observable, a lessee must account for all the payments required by the contract as a lease. The Boards have directed the staff to include application guidance on how a lessee should determine what would be an observable price. Lessors will be required to allocate such payments in accordance with the guidance on revenue recognition.

■ *Sale and Leaseback Transactions.* When a sale has occurred, transactions will be accounted for as a sale and then a leaseback. The Boards have tentatively decided that an entity should apply the control criteria applicable to the proposed new revenue recognition rules to determine whether a sale has occurred. If the sale results in a gain or loss by the seller/lessee, then the gain or loss is to be recognized immediately rather than be amortized over the life of the lease.

Implications and Timeline for Implementation. No decision has been made on when the final rules on lease accounting will become effective. It is believed that the effective date of the rule changes will not be until 2014 or 2015. Many commentators believe that a Jan. 1, 2015 effective date is most likely. Retrospective treatment for two comparable years will mean companies need to be ready by Jan. 1, 2013. However, because the final rules on lease accounting will apply to all leases, whether entered into before or after the rule changes become effective, it is important for companies to understand the impact of the rule changes in order evaluate the impact of the rule changes on existing leases and leases that will be entered into in the future. Not only will the rule changes have an impact on a company's financial statements and possibly its credit rating, but they also have the potential to impact existing commercial arrangements, including credit agreements and incentive based arrangements.

While there may be some time before the new rules become effective, it will take a good deal of time and resources for companies to understand the implications of the rule changes and prepare internally for the new financial reporting and measurement obligations, the impacts on the budgeting and lease versus buy decision making process, as well as to evaluate and implement any new technological or process changes that will be required as a result of the new rules. For companies with significant leases, that means that the time to get ready is now.