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# Lease Accounting Rules Likely to Change, but Not Immediately
## *Would Significantly Impact Balance Sheet*

***By Paul Languirand, CPA***

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) released a revised proposal regarding accounting for leases. It eliminates some of the most controversial aspects of an earlier version but, if approved, would still lead to significant change in lease accounting. If this draft is implemented as is, many companies will be mandated to report far larger amounts of assets and liabilities than currently required.

According to the FASB, the revised proposal "aims to improve the quality and comparability of financial reporting by providing greater transparency about leverage, the assets an organization uses in its operations and the risks to which it is exposed from entering into leasing transactions."

Public comments on the latest proposed rules are due by Sept. 13, 2013. Once the FASB and IASB analyze those comments, the boards will decide whether to issue a final rule, most likely in 2014 if they choose to move forward. However, there would probably be a considerable delay in implementing the new rules because affected organizations would need time to prepare for compliance. In fact, any changes likely wouldn't go into effect until 2017 to give companies adequate lead time and, in some cases, to renegotiate loan agreements that put limits on borrowing by the companies — limits that could appear to be violated if leases are put on the balance sheet.

### About Leasing

For many organizations that need certain assets – whether real estate, trucks, aircraft, construction and manufacturing equipment, or other big-ticket items – leasing is key. It allows companies to access and finance these expensive assets while mitigating exposure to the risks associated with ownership.

According to the FASB, the prevalence of leasing makes it critical that financial statement users have a comprehensive picture of an organization's leasing activities. However, existing accounting models have long been criticized for failing to offer such a view because they often fail to provide a true representation of leasing transactions. In fact, the existing operating-versus-capital-lease standards have been criticized for not accurately representing leasing transactions, and for allowing too many lease assets and liabilities to go unrecognized in financial statements. That's why the FASB and IASB began developing new leasing proposals way back in 2005.

The boards hope that this new draft will remedy the situation and ensure greater transparency in financial reporting.

## About the Proposed Rule Changes

Currently, a majority of leases – even those that are quite substantial – are not reported on a lessee's balance sheet. That's because while lessees and lessors must classify their leases as either finance leases or operating leases, only assets and liabilities related to finance leases are accounted for on the balance sheet. Operating leases are not mentioned.

This system compels businesses to classify virtually all leases as operating leases – a practice regulators say is inadequate because it does not offer a "faithful representation" of leasing transactions.

The proposed rules would require a lessee to recognize assets and liabilities for leases with a maximum possible term of more than 12 months. According to the FASB, "The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee would depend primarily on whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset. For practical purposes, this assessment would often depend on the nature of the underlying asset."

In addition to the reporting requirement, the proposed rules would also change income statements for many companies because the revised accounting practice would require a company to record assets in a different way than they do currently. Instead of listing a $5,000 leased piece of machinery as $1,000 a year for five years, the new rules would force that company to show a larger expense in early years and a smaller one in later years to account for interest – as though the company had borrowed money to buy the asset and then paid it off over five years.

## More Details

There are several other key changes in the revised proposal as compared to the original draft. For instance, the current proposal demands that most real estate leases are accounted for in a different manner than current practice. While they would go on the lessee's balance sheet, the value would be based on the "expected lease payments over the life of the lease." The lessee would not have to assume that it would "exercise renewal options, unless those options were at such favorable prices as to clearly give it a financial incentive to renew." This is a significant change from the FASB and IASB's 2010 proposal.

The FASB also said that in cases where the lease payment is based on something variable, the value would not reflect the expected additional payments. That would hold down the asset value and related debt. If the variable in question is an index, such as the Consumer Price Index, the initial lease value would be based on the current level of the index, and then the asset value and related liabilities would be updated annually to keep pace with the changing index.

Because there exists a variety of lease transactions with different economics, the latest rules draft proposes a dual approach to the "recognition, measurement and presentation of expenses and cash flows arising from a lease." For most real estate leases, a lessee would have to report in its income statement a straight-line lease expense. For most other types of leases, a lessee would report amortization of the asset separately from interest on the lease liability. Note that some board members strongly disagree with the plan to treat real estate leases differently than other types of leases.

In addition, some others in the accounting industry have voiced their concern, wondering whether bringing leases on the balance sheet would represent a sufficient enough improvement over existing lease accounting standards to satisfy financial statement users and justify the considerable cost of implementation.

Stay tuned.

## For More Information

If you have any questions about the proposal regarding accounting for leases, please contact your CBIZ Tofias & Mayer Hoffman McCann advisor, or you may reach us at TheBottomLine@cbiztofias.com and 888.761.8835.

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