Proposed Lease Accounting Rules May Require a Change in How You Do Business

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The Financial Accounting Standards Board (FASB) has proposed significant changes to accounting for leases. If your business uses leases to finance long term assets, you should be familiar with these proposed changes. The off balance sheet financing currently available under the existing lease rules would be substantially eliminated. This article will summarize current lease accounting standards, the proposed changes, and the potential impact to your business if these changes are confirmed.

This project is a joint effort between FASB and the International Accounting Standards Board (IASB). Both U.S. and international accounting standards currently classify leases into two categories: capital leases and operating leases. The proposed rules would essentially remove the favorable off balance sheet accounting under the operating lease option. FASB is currently reviewing the public's comments on these proposed changes and if FASB makes a final decision in 2011 regarding the proposed changes to lease accounting, the new rules could go into effect as soon as 2013.

Due to the highly publicized accounting scandals over the last decade, FASB has been targeting off balance sheet financing. Most notably were the new standards on consolidation of variable interest entities. The Securities and Exchange Commission did a study in 2005 that estimated the undiscounted amount of off balance sheet lease obligations at $1.25 trillion.

Existing lease accounting models require lessees to classify their leases as either capital or operating. If the terms of the lease contract meet certain criteria it is required to be classified as a capital lease with the asset and the liability recorded in the financial statements. For instance, if the lease had a bargain purchase option at the end of the lease or if the lease transferred ownership to the lessee at the end of the lease term, the lease is required to be recorded as a capital lease. However, if the lease does not meet at least any of the tests as stated in the current accounting standards, the lease is accounted for as an operating lease. Many leasing companies were wise to these rules, and structured leases so they would not meet the capitalization rules. As such, FASB and the IASB believe these models have led to lack of comparability in financial reporting. As a result, it makes it difficult for users of financial statements to properly evaluate these future cost obligations.

The proposals for new lease accounting, if approved, result in significant changes to the accounting requirements for both lessees and lessors. Substantially any entity that enters into a lease would be affected by the proposed requirements. The lessee would recognize an asset (a "right to use" asset) and a liability to make lease payments. Although entities that already account for their leases as capital will be less affected, changes in the measurement of the assets and liabilities arising from those leases could occur because of the proposed changes to account for leasing options and contingent rentals. In addition the pattern of income and expense recognition in the income statement could change. It should be noted however, there would be simplified requirements for leases of 12 months or less.

The impact of recording these lease obligations on the balance sheet can have multiple impacts that should be considered. For instance, lender ratios and financial ratio covenant requirements can be significantly affected causing entities to become non-compliant with lenders. Also, financial ratios used by lenders and vendors to evaluate the entities credit worthiness could be impacted. In addition, closely held businesses typically own property in a separate entity and lease the property back. In most cases, these leases were already essentially capitalized in the entities financial statements as a result of the consolidation rules related to variable interest entities. However, there were certain instances where consolidation was not required. With the proposed rules, these off balance sheet arrangements could go away.

Although the ultimate final accounting rules could change due to the public's comments to the exposure draft, you should be considering the impact to your business now, if operating lease accounting will no longer be available.

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