



The Lease Accounting Bungee Cord

Accounting rules in a post-Enron world are constantly in a state of flux.

Background

Historically, a cardinal accounting principle has been to determine whether a lease is an operating lease or a capital lease for financial statement purposes. Operating leases are currently accorded income statement treatment, with lease payments expensed as they are due--hence the term "off balance sheet financing." Capital leases, on the other hand, are given balance sheet treatment, with the booking of an asset (usually depreciable) and a liability.

Anticipated Change

As has been spoken about recently, starting in 2014, all leases would be required to be placed on the balance sheet. The magnitude of such a change would be enormous, both on a global or even a nationwide basis. In the U.S., it is estimated that there are some \$1.2 trillion of leased assets, including construction, transportation, manufacturing and medical equipment.

The specter of such a fundamental accounting change would directly impact numerous accounting ratios as well as evaluations of a company's bonding capacity or borrowing capability. The imminent revision in accounting standards seemed to really stretch the bungee cord of lease accounting to the max, creating significant tension in anticipation of dramatic effects occurring as a result of the sudden change of a longstanding fundamental accounting rule.

The Bungee Cord Brings Us Back

The foregoing proposal proved to be quite controversial indeed. As a result, the Financial Accounting Standards Board (FASB) decided that the long established practice of having two categories of leases might make sense after all. Therefore, the FASB, together with the International Accounting Standards Board (IASB), is now considering dividing leases into two types: finance leases and other-than-finance leases.

Other-than-finance leases would be treated like the operating leases of today and they would not be capitalized. Finance leases, however, would be treated like capital leases of today, resulting in setting up an asset on the balance sheet and a corresponding liability that would be paid down with each installment earmarked toward the acquisition of the asset.

The FASB and IASB staff will evaluate exactly how to determine the difference between these two types of leases, procuring commentary from informed sources as they develop their recommendations. It appears that both boards will also address how to take renewal options into account in determining the amount of a liability for leases that are capitalized. The boards also decided that lessors and lessees should both follow the same guidelines in addressing the effect of variability (such as index or rate variations) on the amount of the receivable or liability. The boards will in addition require that the calculation of a liability should take into account residual value guarantees and penalties for term options.

Conclusion

The bungee cord appears to be headed back close to where we started and marks the third time in recent history that the FASB has sprung back from controversial proposals. The first two bounce-backs dealt with a proposal to record assets and liabilities at fair value and a total revision of the rules governing how to account for contingencies. It is hoped by many that the current retreat on lease accounting will permit greater consistency with today's practice of accounting for leases, thereby paving the way for a smooth, methodical, subdued transition to new rules, instead of a drastic, bold, momentous change.

Large & Gilbert is committed to staying on top of this changing accounting landscape and will continue to keep you informed when changes are imminent.

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