

FASB Lease Accounting

An exclusive article series designed to keep you informed.



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The Future of Leasing

As we mentioned in our first two articles, “Operating Leases Moving to the Balance Sheet” and “Principles-Based Accounting for Leases,” the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are discussing changes to lease accounting. In a Discussion Paper titled *Leases: Preliminary Views*, the FASB has agreed to eliminate off-balance sheet accounting for operating leases. If finalized, all current and future leases will be recorded on the balance sheet as assets and liabilities.

Business practices and the form of lease agreements have evolved over the past decades based on an accounting model that does not recognize an asset or liability for operating leases. It is reasonable to assume that some of those practices will change as lessors and lessees adapt to the changed accounting environment. Of course, those changes are still under discussion; they may not be issued until 2011 and may not take effect until 2012 or later. Since the Discussion Paper does not include grandfathering provisions, it is not too soon to take into account the potential effects of likely changes in lease accounting when evaluating, negotiating or amending agreements with a duration of more than two or three years.

This article discusses some of the ways that a change in lease accounting could affect business practices and suggests some “stress tests” that could be used today to determine whether an arrangement will still meet your needs in the future. The table at the end of the article includes some items to consider when evaluating current and future leasing contracts.

Loan agreements

When negotiating, or renegotiating, loan provisions that could remain in effect for more than three or four years, consider the potential impact of capital leases on your balance sheet. Any provisions that refer to amounts on the balance sheet or financial ratios should be re-examined in light of possible changes. Consult with your lending institution and other business advisors to determine how these changes could affect compliance and whether it is possible to plan ahead to avoid any unintended consequences.

New or extended leases

If balance sheet presentation is currently a factor when making “lease or buy” decisions, the decision-making model should be reconfigured to take into account potential elimination of operating lease accounting. Provisions specifically designed to achieve operating lease accounting may no longer be necessary or economically advantageous. The desirability of special purpose leasing entities should also be carefully considered. Consult with your business, tax and legal advisors to ensure that your arrangements will still make sense in the changed environment.

Sale and leaseback

Sale and leaseback is often a cost-effective means of accessing cash. However, if balance sheet presentation is a factor in making the decision to engage in a sale and leaseback, be aware of the effects of possible changes on subsequent accounting. The elimination of operating lease accounting may also affect the utility of provisions specifically designed to achieve sales recognition and operating lease treatment, especially in regard to transactions involving real estate. All provisions designed to address continuing involvement issues or to achieve operating lease accounting should be reevaluated with the assistance of your business, tax and legal advisors.

Other agreements

Although most of the proposed changes will affect the balance sheet, some provisions may affect reported income. One proposed change would recharacterize rent expense as depreciation expense and interest expense. Naturally, this would affect EBITDA. The total amount of income in any period also may change due to timing differences, with higher expenses likely in the early years of a lease. All existing and proposed agreements that refer to EBITDA or other income measures should be reviewed to ensure that the likely impact is understood and fully considered. As always, consult with your business, tax and legal advisors to help minimize any unintended consequences.

Agreement	Implications	Stress test
Loan agreements	Lease obligations coming onto the balance sheet three or four years out could trip loan covenants.	Test proposed covenants against a pro forma balance sheet that includes current leases, likely lease renewals and likely additional leases.
New or extended leases	Changes could affect the outcome of current “lease or buy” evaluations and the tailoring of terms to achieve operating lease classification.	Revise lease or buy tests to incorporate possibility of new accounting for leases. Calculate costs/benefits with leases on the balance sheet.
Sale and leaseback	Changes could affect the desirability of terms tailored to achieve sales recognition or operating lease classification.	Evaluate the decision with and without sales recognition and with or without operating lease classification.
Other agreements	Changes may alter the impact of provisions based on measures such as EBITDA.	Evaluate the impact on covenants or agreements that refer to EBITDA or similar measures by recasting rent expense as interest and depreciation.

What's next?

It is not too early to begin planning for these substantive changes to lease accounting. When designing your financing and negotiating leasing terms, the possibility that the new rules will be in

effect within the next several years should be explicitly considered. While there are many sound economic reasons for engaging in lease transactions, the likelihood of favorable accounting treatment should be continuously reevaluated as the project progresses.

As you enter into new negotiations, be sure to consult with your professional advisors to ensure your strategy will make sense if and when the changes go into effect. Your professional advisors can also keep you apprised of the status of the overall project to revise lease accounting.

For a copy of our past issues click the links below:

- Article One: [“Operating” Leases Moving to the Balance Sheet](#)
- Article Two: [Principles-Based Accounting for Leases](#)

Additional Resources:

www.fasb.org

www.iasb.org

[AICPA: FASB/IASB - Leases FAQs](#)

[Grant Thornton: *New Developments Summary*, “FASB and IASB express views on accounting by lessees”](#)

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