Accounting for Leases:
Off-Balance Sheet Lease Arrangements About to Become Extinct Although Patterns of Expense Recognition Will Still Vary

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Accounting for leases – primarily by lessees – has been a contentious matter for decades. With the exception of certain short-term leases, these are financial arrangements that provide the lessees with rights to use property, real or personal. The corresponding obligation to pay for those assets quite often equate to the full purchase cost that would have been incurred had the assets been acquired outright. Nevertheless, companies entering into such long-term "capital" or "finance" leases have long fought to have these assets and liabilities excluded from their balance sheets. The leasing and finance industries have been outspoken in fighting expansion of mandatory capitalization by lessees, fearing loss of appeal of lease products should accounting advantages be eliminated.

Small steps were taken in the 1960s to conform financial reporting regarding leases to economic reality for both lessee and lessor. A much more substantial change was made in 1976, with the promulgation of FASB Statement No. 13, which was followed by dozens of amendments, interpretations, and Emerging Issues Task Force consensuses over the next 25 years. This standard set four "bright-line" tests for mandatory lease capitalization by lessees. These four, plus another two, apply for lessors. This resulted in the formal recognition of many, but not all, long-term leases in the financial statements of lessees, with a concomitant de-recognition from the financial statements of lessors.

However, because FAS 13 and its associated rules relied upon the application of mechanical criteria, it was unfortunately rather easy to create lease contracts that evaded the spirit of the requirements. The most infamous of these was the threshold criterion that if the present value of the minimum lease obligations were 90% or more of the leased property's fair value at contract inception, capitalization would be indicated as necessary. This has been avoided by writing "89% leases" that could retain operating lease accounting.

Currently, the FASB and its international standard-setting partner, IASB, have agreed on a new, uniform approach that arguably will result in capitalization treatment of virtually all leases of more than one year's duration. In a departure from current practice, in such instances the assets to be recognized will be intangible assets to be denoted as rights of use, rather than as physical assets, such as automobiles, buildings, or machinery. The principle is essentially identical to what are currently deemed as capitalized lease assets. However, in a change, the pattern of expense recognition will differ between leases involving real and personal property, albeit both will have certain exceptions. This change is apparently being made as a nod toward popular expectations, and not because of any inherent differences between the two.

For leases of real property (which FASB is simply labeling as "property") lease expense will be recognized on a straight-line basis over the lease term. The exception is if "a major portion" of the underlying assets' useful lives, or present value of fixed lease payments, equates to substantially all of the underlying assets' fair value. Lease-related costs involve interest on associated lease debt, which is to be presented in the lessee's balance sheet, and amortization of the intangible lease asset. The interest portion will have to be recognized on a declining pattern as debt is reduced over time. Because of these factors, the only way to obtain flat-line lease expense over a number of years is to implicitly employ an increasing-charge method of amortization.

For leases of personal property (which FASB is referring to as “other than property”), such as machinery and vehicles, in most cases the lease expense will show a declining pattern over time. Straight-line amortization of the lease asset will be added to the declining interest charges related to the declining balance of the lease obligations being reported in the balance sheet. However, if the lease term is an insignificant portion of the asset’s life, or if the present value of the obligation is insignificant relative to the asset’s value, then a straight-line total lease cost pattern is to be effected, as it is for most real estate leases.

Thus, although a major motivation for development of this standard was dissatisfaction with the easily-evaded “cookbook recipe” thresholds under FAS 13, the new standard will invoke qualitative criteria involving “significant” and “substantially all” thresholds, which can be finessed by wily preparers. However, in the new setting, evasion will only alter the pattern of expense recognition, and will not result in full operating lease treatment, since all leases extending beyond one year’s duration will definitely trigger asset and liability recognition on the balance sheet.

The new standard, when issued, will likely require retroactive restatement of financial statements. This may create unpleasant surprises for reporting entities and their lenders alike, because newly recognized leases will cause debt-equity ratios to be altered, quite possibly creating apparent violations of loan covenants or other mandates. For this reason, early attention to this proposal is strongly encouraged, including preparation of “pro forma” historical financial statements which can be shared with creditors to demonstrate that this accounting change triggers breaches that might be more apparent than real. Doing so might convince lenders to rewrite the affected covenants or to insert “frozen GAAP” provisions that cover the remaining terms of the affected loans. In this situation, an ounce of prevention will be worth many pounds of cure.

About the Author: Barry Jay Epstein, Ph.D., CPA, CFF, a litigation consultant with Cendrowski Corporate Advisors, has over 40 years experience as an accountant, auditor, lecturer, writer, and financial executive. Dr. Epstein specializes in the areas of white-collar defense, financial reporting fraud and securities litigation, accountants' liability and accountant malpractice, and advises preparers and auditors on technical GAAP, GAAS, and IFRS matters. He can be reached at **866-717-1607** or bje@cendsel.com.