

Boards Go Back to the Drawing Board With New Lease Exposure Draft

In August 2010, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) released for public comment, joint proposals to improve the financial reporting of lease contracts. If adopted, the proposals would create a new accounting model for lessees and lessors and eliminate the concept of operating leases entirely, becoming effective as of the date of the initial application, with no grandfathering of existing leases.

Now, nearly a year after the initial comment period closed, the IASB and FASB have gone back to the drawing board with a new exposure draft. This action was taken in part because the decisions made to date have been sufficiently different from those published in the first exposure draft. Discussions have included issues of scope, the application of financial asset guidance to the right to receive lease payments, other subsequent measurement issues for lessors and the accounting for residual value guarantees by lessors. The boards believe that these changes warrant an exposure of the revised proposals.

In its first round of comments, the exposure draft received mixed reviews from critics. John Hepp, a partner in the accounting principles consultation group for Grant Thornton, is among them.

“Lease accounting is a very complicated area. It is also a very important area in business finance. It allows businesses to ramp up capacity and obtain the best financing rates and provides lenders with better security,” said Hepp. “Some of these arrangements are similar to a long-term financing arrangement, but others are flexible arrangements that help businesses fulfill immediate and sometimes temporary demand. The flexibility of leasing can be especially important for small businesses and startups. However, the proposed standard considers all leases to be financing arrangements, and I don’t think this is true. This is just one of the issues that need to be addressed before the finalized rule comes out.”

Hepp notes that the lessor and lessee models also need improvement. He believes that the lessor model should ultimately align with the proposed standard for revenue recognition of contracts with customers to provide a unified model to recognize all revenue transactions. For the lessee, it is the issue of timing expense recognition not on the financial side that Hepp believes needs attention.

Regardless of whether these changes are incorporated or not, the new exposure draft will likely affect the way that businesses operate.

“On the administrative side, there will be higher costs because the requirements are considerably more complex,” said Hepp. “However, the users of financial statements will benefit if these changes make it easier for them to see how much money businesses have committed to operating leases.”

While Hepp believes that it is too early for business to take definitive steps to change their accounting systems to prepare for whatever the final rules entail, they should ensure that their loan covenants are robust enough to accommodate a change in generally accepted accounting principles (GAAP). Businesses should be particularly aware of the possible implications when entering into sale and leaseback transactions involving real estate.

“My strongest advice would be to watch for this exposure draft coming out and take a look at it. Get some advice if you need it and comment on it,” said Hepp. “Let the boards know what you think about it. This is a once-in-a-generation type of thing, and we will have to live with whatever comes out of this process for 20 or 30 years. So we might want to see to it that it’s done right.”