

2009–10

February 26, 2009

Leases- A Preview of What's to Come A Preview of What's to Come

At a glance

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- The FASB and the IASB will be issuing a Discussion Paper in March 2009 on lease accounting that will impact all companies.
- The proposal eliminates operating lease accounting. All leases will be treated in a manner similar to how capital leases are accounted for today.
- The Boards expect to release an exposure draft in 2010. A final standard will likely not be issued until 2011.
- Companies should consider the impact of the proposed model on their business activity, financial statement presentation, key financial metrics, internal controls, and lease accounting systems.

Background

While the basic lease accounting model hasn't changed in more than 30 years, it has been the subject of significant criticism for almost as long. At a time when there is a push for more principles-based accounting standards, Statement of Financial Accounting Standards No. 13, *Accounting for Leases* (FAS 13), with its many "bright-line" thresholds that determine lease classification is the example cited most often as reflecting the problem with form-driven rules.

Many observers believe FAS 13 is not consistent with the current Conceptual Framework, which provides the underpinnings for U.S. GAAP. The arbitrary "bright lines" in the guidance also allow companies to structure lease transactions to result in operating lease classification. Critics also point out that the current standards permit, for example, a commercial airline company to have no airplanes on its balance sheet.

In June 2005, the Securities and Exchange Commission (SEC) issued its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Users*. One recommendation in this report was that existing lease standards needed to be rewritten.

In 2006, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the "Boards") agreed on a joint work plan (Memorandum of Understanding) to expedite global convergence in accounting standards. In connection with this process, and in response to the criticisms noted above, a joint FASB/IASB project to address lease accounting was added to the Boards' agenda. The project was intended to build on previous work contained in the 1999/2000 white paper entitled "G4+1 Special Report, *Leases: Implementation of a New Approach*."

The joint project, as originally conceived, would have addressed lessee and lessor accounting. However, the project has since been scaled back to address only lessee accounting.

Key provisions

A significant step in the project plan is the issuance of a Discussion Paper, anticipated to be released for comment in March 2009. Based on the Boards' deliberations to date which may be subject to change, the Discussion Paper is expected to propose significant changes to lessee accounting. Although the Boards believe that the accounting by lessors is more appropriately addressed in their ongoing Revenue Recognition project, the Discussion Paper will provide a high-level overview of potential lessor questions and considerations, but will not include any preliminary views on lessor accounting.

For lessees, the high-level direction of the leasing project is clear. After considering a number of alternative models and debating their relative merits, the Boards have tentatively settled on a right-of-use model. This model would require the lessee to recognize an asset representing its right to use the leased asset, and a corresponding liability for its obligation to pay rent. Under the right-of-use model, operating lease accounting under FAS 13 would be eliminated, and lessees would account for all leases in a manner similar to that used for capital leases today.

Although the Boards are sensitive to the cost-benefit considerations for small-dollar and short-duration leases, the Boards have yet to address this concern. The idea that small-dollar leases would be exempt from the new standard is troubling to certain Board members because leases that are individually low dollar may be material when aggregated. Further, it is likely that some type of bright-line threshold would be necessary to implement such an exception. As noted, similar bright lines in the current model have been the target of significant criticism.

The Boards have not agreed on a single view on how to deal with some common features contained in many lease arrangements (for example, options to extend, contingent rent, executory costs, options to purchase). As a result, the Discussion Paper will include several alternatives and solicit preparer, auditor, and user perspectives through the comment letter process. Even where the Boards tentatively agreed on a single view, more time will be needed to identify and resolve potential inconsistencies within the Discussion Paper as deliberation on other issues continues.

PwC Observation: We agree that the accounting guidance for leases needs to be reconsidered. The current accounting for leases takes an "all or nothing" approach to recognizing leases on the balance sheet that provides for significantly different accounting for transactions with similar economic substance. While our views may differ in some respects from those discussed by the Boards, no final decisions have yet been made. We support the broad direction of the Boards in developing the new lease accounting model, and will provide the Boards with our views, both formally and informally, as the project develops.

Potential Implications

The proposed accounting model would have the greatest impact on lessees of significant amounts of "large-ticket" items, such as real estate, manufacturing equipment, power plants, aircraft, railcars, and ships. However, the revised standard would also affect virtually every company, including those who lease computer equipment, copiers, office furniture, and telecommunications equipment.

The proposed model would require lessees to remeasure their lease obligation at each balance sheet date based on updated estimates, including the probability of exercising renewal options and the amount of contingent rent that the lessee expects to pay over the revised lease term. The remeasurement of the obligation would be reflected as an adjustment to either earnings or the right-of-use asset, depending on the nature of the change. This would require incremental effort compared to the current model where lease accounting is set at inception and revisited only if there is a modification or extension of the lease.

The right-of-use model will impact financial statement presentation and financial metrics, including many that tie directly to debt covenants or compensation arrangements. For example, for a lease currently accounted for as an operating lease:

- Balance sheets will be grossed-up for the right-of-use asset and the lease obligation.
- The expense recognition pattern will change, resulting in expense higher than straight-line expense during the early part of the lease term and lower during the latter part of the lease term.
- EBITDA will likely increase as rent expense will be replaced with interest and amortization expense, which are generally below-the-line charges.

Because these changes may change the economics of leases written in the future, companies may need to reexamine "lease versus buy" decisions.

Given the long-term nature of many leases and the desire for comparability, it is unlikely that accounting for existing leases will be grandfathered. Accordingly, management should consider the implications of these potential changes as they negotiate long-term leases, even before the effective date of the new standard.

In evaluating the model proposed in the Discussion Paper, companies should also consider the potential impact on their business in areas such as lease accounting systems and internal controls.

Timetable

The Discussion Paper is expected to be issued at the end of March 2009, with comments due by July 2009. The Boards will then consider the comments received and continue their deliberations on specific issues, with the expectation of issuing an Exposure Draft of the new standard in the first half of 2010.

The Boards expect a final standard to be issued in 2011, although the Boards have yet to discuss the effective date and transition provisions.

Questions

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