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GAAP Lease Accounting Standards: Proposed Changes and Business Considerations

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On August 17, 2010, the Financial Accounting Standards Board ('FASB") issued Proposed Accounting Standards Update, Leases (Topic 840) ("PASU 840"). PASU 840 sets forth new methods for reporting long-term lease obligations (leases for periods of 12 months or longer) that will impact financial reporting for both lessors and lessees under GAAP. The FASB indicated that the final standards will be issued sometime during the second quarter of 2011.

The changes proposed in PASU 840 will require companies to record all existing and future leases as assets and liabilities on their balance sheets, which will effectively eliminate the concept of operating leases from GAAP. These changes may affect your company's ability to comply with loan covenants and affect your income tax obligations.

Key Changes for Lessees

As noted above, under PASU 840, companies will be required to recognize leases as assets on their balance sheets. A lessee's obligation to make lease payments under a lease will be capitalized based on a present value approach.

If your company previously classified long-term leases as operating leases, amounts that were previously booked as rent expenses will be replaced with an amortization expense of the capitalized asset and interest expense to account for the time value of the liability to make lease payments.

PASU 840 also proposes changes to the treatment of leases in your company's cash flow statements. Currently, under GAAP, operating lease payments are treated as operating cash outflows. Lease payments under PASU 840 will be treated as financing cash outflows.

Further, lessees will need to identify and explain amounts recognized in their financial statements arising from leases and describe how contingent payment provisions and lease options may affect the amount, timing, and uncertainty of future cash flows.

Key Changes for Lessors

PASU 840 requires Lessors to apply one of two lease accounting models. The method that your company will use will depend on how much risk and benefit your company retains with respect to a particular leased asset. For those leases where a company retains a great deal of risk and benefit with respect to the leased asset (e.g., where the lessor maintains true ownership over the asset), the leased asset will remain on the lessor's books, with the lessor recording a receivable for the expected lease payments and a corresponding payment liability, similar to an entry for deferred revenue.

Lessors will apply the second model to all other long-term leases. Under this approach, a portion of the leased asset will be removed from the lessor's books, with the lessor recording a receivable for the expected lease payments and a residual asset for the right to ownership at the end of the lease term. Lessors will recognize expenses over time for the portion of a leased asset that is removed from their books. Companies using this approach may net lease income and expenses, but will be required to book lease interest income separately from other interest income and continue to depreciate the residual leased asset.

The Impact of PASU 840 on Your Business

PASU 840 takes from lessees one of the advantages of leasing – the luxury of "off-balance-sheet" financing. Recording leases on the balance sheet as assets and liabilities can result in lower asset turnover ratios, lower return on capital, and increased debt to equity ratios. To be prepared for the impact of these accounting changes, you should gain familiarity with your company's loan covenants and learn how an increase in the company's debt to equity ratio may impact your company's borrowing capacity. A preemptive calculation of your company's loan covenants using these new methodologies will ensure that the company will have cash available to fund operations going forward and remain in compliance with its loan documents.

These new lease accounting models may also result in temporary differences for income tax reporting, and may affect the calculation of any state and local taxes to the extent those taxes are based on GAAP.

To avoid loan covenant issues or tax issues related to lease accounting, your company may need to execute shorter-term leases, which may result in greater rental payments, or purchase (rather than lease) assets.

Knowing in advance that the accounting changes will adversely affect your business will also give you time to discuss any necessary changes to your company's financial ratios with your lender and to develop strategies for obtaining the assets your company needs (either by lease or purchase) before the changes are implemented.

Lessors will need to monitor deferred income that arises under the terms of each lease to which it is a party and keep track of any lease terms that may cause unexpected fluctuations in income such as contingent payment obligations and lease term options.

For more information on how the changes proposed to the FASB will impact your business please contact Cindy Bergmann at 312.360.6652.