GASB takes on a Lease Accounting Change Project
There is risk that it will cause the cost of municipalities' debt to increase

On November 11, 2014 the Governmental Accounting Standards Board (GASB) issued a Preliminary Views document on a project to change current GASB lease accounting GAAP to be in line with the results of the soon to be completed FASB/IASB Leases project**.** Any comment letters must be submitted by March 6, 2015.

The preliminary views by the GASB include following the IASB single lease model for lessees and a direct finance lease only model for lessor accounting. In my opinion both of those decisions will obscure financial results of municipalities. If enacted as is the results are more a real estate leasing issue and a general debt rating/debt cost/availability of credit issue for municipalities. One other concern I have is that the GASB is taking a different approach than the FASB, which approach I agree with. The FASB is trying to converge with the IASB in their Leases project but we need to support the FASB view which best presents the economics of lease transactions in the financial statements of lessees and lessors.

Background
The current GASB accounting rules incorporate the FAS 13 lease accounting rules virtually word-for-word. Briefly, under both the FASB and GASB rules lessees account for leases as either operating leases (off balance sheet with straight line rent expense) or capital leases (on balance sheet as a depreciating asset and a liability with imputed interest). Lessors account for leases as either direct finance leases (receivables and residuals are the leased assets and finance lease revenue is recognized using the interest method) or operating leases (leased asset is a depreciable asset and rents /residual are the revenue elements). Also the GASB rules disregard (and will continue to disregard) fiscal funding or cancellation clauses for lessee lease classification/financial reporting purposes if the possibility of cancellation is remote. Fiscal funding clauses are present in leases that qualify as tax exempt (lessor's revenue is exempt from Federal income taxes) leases, aka muni leases. Muni leases are the most common type of equipment leases used by municipal government entities. These leases are classified as capital leases (on balance sheet as a physical asset and debt) under current GASB GAAP. Typically operating leases done by municipalities as lessee are office space or other real estate leases. They are off balance sheet under current GASB GAAP as they are executory contracts under US bankruptcy rules and as such do not create an asset or debt in a bankruptcy liquidation.

FASB/IASB approaches:
The main objective of the FASB/IASB Leases project is for lessees to capitalize all operating leases, other than short term leases, as an asset and liability. The FASB and IASB are not converged on lessee accounting – the IASB adopted a capital lease accounting for ***all*** leases model which the GASB is following. The FASB is keeping risks and rewards based lease

classification tests in place (with minor changes to remove the "bright lines" present in the FAS 13 classification tests) and treats capitalized operating leases differently from capital leases. Under the FASB approach the operating lease cost is the straight line rent expense and the operating lease liability is reported as an "other" liability – not debt. The capitalized lease asset is also separately reported as a right –of-use asset.

Regarding lessor accounting both the IASB and FASB have decided that current GAAP should not change in any material way. The GASB on the other hand is proposing to eliminate operating lease method for governmental entities that act as lessors. The only area where I see significant leasing as a lessor is leasing real estate – either as an owner/lessor or a sub-lessor. The idea of lessor accounting for lease of a part of a building (like excess office space) as a direct finance lease is not practical as the fair value and residual value are not readily determinable – as such one cannot calculate the implicit rate in the lease.

GASB Proposed Approach:

The GASB proposes that lessees apply capital lease accounting to ***all*** leases. They would label the resulting asset an "intangible" asset contrary to the tangible asset that results under current capital lease accounting. I could see a capitalized operating lease creating an intangible asset as the right of use is a contract right. The proposed P&L lease cost is ***front loaded*** as interest is imputed on the liability. The liability is considered debt for ***all*** leases.

In my opinion such change by GASB would not impact ELFA member government lease lessee behavior, as, in my experience, the vast majority of government leases (AKA muni leases) are tax exempt leases which by definition are capital leases – this means they should all be capitalized now under current GASB GAAP. What would be impacted are the reported results of newly capitalized FMV equipment leases and real estate/office space leases. Under current GASB GAAP they are off balance sheet with level rent expense.

Impact on Debt Rating Models and Cost of Debt/Bonds:

The proposed changes to operating lease accounting will negatively impact three areas that make up 20% of the debt rating "score" in the Moody's muni debt rating score card. The areas impacted are Operating History (revenue to expense ratio), Debt to Full Value (ratio of debt to taxable rate base) and Debt to Revenue (ratio of debt to tax revenues).

Front ending lease costs on FMV equipment leases and real estate operating leases will generally deteriorate the Operating History ratio under the concept of capital lease accounting for operating leases. It is true that over time the front loading versus level rent expense is a timing difference and lease costs will generally level as new leases replace old leases. Unfortunately the reality is the lease cost will be inconsistent or "lumpy" from year to year.

The front ending effect is greater the longer the lease term and real estate leases are medium to long-term.

The two debt ratios will worsen as the capitalized operating lease liability is considered a new debt (it is an executory liability which is not debt in a bankruptcy). The result should be deterioration in debt ratings and higher new issue debt costs for the municipality for no reason but a change in thinking by the GASB. The credit quality of the governmental entity will not have changed.

Impact on Credit Quality:

Naturally a mere change in accounting does not impact the ability of a municipality to meet future obligations but the changes will cloud the ability of a lender/lessor/rating agency to understand the financial results where operating leases are present in significant amounts. I can envision a municipality recasting its lease accounting to provide potential lessors and lenders as well as credit rating agencies with the true "picture". I see this as an added cost and complexity burden that may be required to get the best bond rating or to get approved for a new lease or loan.

Conclusion

The preliminary view that all leases are the same is another example of an accounting theory that has no basis in the legal treatment of leases. The legal treatment is what defines whether a lease creates debt or an asset in reality. The decision whether to comment or now is being considered by the ELFA. It does not seem to be our fight except for the concern that the FASB may change its mind on the lessee accounting model. We are also concerned that the process of reviewing muni credits will require more work for lessees and their lenders/lessors. I would hope that municipalities and the rating agencies send in comment letters.

About the Author:

Bill Bosco is the Principal of Leasing 101, a lease consulting company. Bill has over 40 years experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the EFLA accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group as a representative. He can be reached at wbleasing101@aol.com, www.leasing-101.com or 914-522-3233.