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Why Bankruptcy Should Matter in Lease Accounting

A new approach to change lessee cost patterns is gaining momentum with FASB and IASB members.

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For years, some rather basic bankruptcy concepts have not applied to lease accounting. That may soon change if the Financial Accounting Standards Board and the International Accounting Standards Board finally come together on a new approach that follows common bankruptcy laws.

The bankruptcy idea can be boiled down to a simple example: if a company that's now bankrupt previously borrowed to buy an airplane, then the airplane is an asset of the bankrupt estate and the liability includes a claim on the company's assets. But if such a company leases the plane and then goes bankrupt, the firm would have to give the plane back to the lessor. When the asset is given back, there is no future use and no future liability.

That same kind of thinking, industry participants say, should be applied when capitalizing operating leases, those leases that transfer the right to use a property. Taking such an approach would clear up the currently confusing array of responses to the question of how lease liabilities should be accounted for in the case of nonbankrupt companies.

Until now, previously proposed methods considered the lease cost a liability throughout all economic stages. But a new approach backed by a number of trade groups, the Whole Contract Method, a.k.a. Approach D, adjusts the lease liability on each balance-sheet date to be the present value of remaining lease payments. Perhaps more importantly, unlike other methods, the new approach would more closely align with generally accepted accounting principles.

While all of the other approaches to reform lease accounting are designed to eliminate off-balance-sheet leases (with the exception of leases of less than 12 months), FASB and the IASB only recently considered the new Approach D. At their joint meeting last February, it was not even up for discussion.

A lease had been considered something that was purchased for a period of time and in which one owes an interest-bearing obligation, says Bill Bosco, president of lease-accounting firm Leasing 101 and a technical consultant at the Equipment Leasing and Financing Association (ELFA).

Several of the previously proposed methods were either "front-loaded" (in which lease costs are placed at a higher level in the beginning of a lease than at the end) or based on estimated values for rent over time rather than taking into account the different stages of a lease.

Finding the right approach has been hard. "The strange nature of [lease-cost] liability is that it's a liability if it's a going concern but not if you're bankrupt," says Bosco. "It's not a debt in bankruptcy, nor does the IRS view it as debt."

How lease costs should be treated in income statements and how rent payments are to be treated in cash-flow statements have been matters of debate. FASB noted that previous models "have been criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions."

The previous approaches vary greatly:

- The right-of-use approach (ROU) takes the underlying asset of the lease and amortizes it by moving it in a consistent manner between financial statements and in a straight-line fashion.
- The interest based amortization approach (IBA) considers the timing and amount of rent payments when amortizing a property, for example.
- The underlying asset approach (UA) amortizes based on estimated calculations for the decline in value of a property or asset.

All of the proposed approaches have drawbacks. The problem with the ROU method is that the asset can be worth less than the liability, since the method doesn't take into account present value, explains Bosco. "The value of the asset and liability should be the same throughout the life. The P&L as a result can't be front-loaded; it must be level."

The three previous methods also do not accrue the average rent, for example, as the reported lease cost: an approach that would not provide as accurate a reading of the rent as Approach D would, according to Bosco. The IBA approach has been criticized for being overly complex and works best if rents are level, while the UA approach forces the lessee to make lots of estimates. FASB had originally favored the IBA approach, while the IASB favored the UA approach, according to a source familiar with the talks.

Even Approach D has come under scrutiny. The Internal Revenue Service is still puzzled by whether or not there should be an interest expense recorded in Approach D, since payments are made over time, notes Bosco. But the IRS, he says, is failing to recognize that payments are made under an executory contract, in which one or both parties still have such obligations to perform, as a landlord has to a tenant. He says the contracts are not considered a liability in bankruptcy but as a periodic expense.

The ELFA, for one, has long supported Approach D as a better reflection of the economic effect of a lease in financial statements. Earlier this month, the ELFA said that "changing the lessee cost pattern is the most significant unresolved issue that is holding up the issuance of a new exposure draft for FASB's Leases Project."

This sentiment is echoed by the Institute of Management Accountants and Financial Executives International (FEI), which both want the issue to move forward and tout the use of Approach D as an alternative to the other methods discussed.

In a comment letter last month to the IASB, FEI executives noted that Approach D largely "preserves the existing presentation of operating leases in the lessee's statement of earnings and statement of cash flows, while accomplishing the goal of reflecting the present value of the lessee's future payments to the lessor in the statement of financial position."

The new FASB/IASB discussions are a step in the right direction, according to Bosco. But more work needs to be done to pass the new approach through both boards completely. "It remains to be seen that the IASB will agree to it," he says. "A lease is a simple document, but the legal and tax accounting nuances make it very complex."

Even though there have been some common themes that have recently surfaced from member feedback, not everyone is likely to be happy with the approach that will eventually be chosen, says the source familiar with the discussions.

FASB and the IASB will be discussing the issue at their May 21–24 joint meeting, while a final decision is expected at their June board meeting. An exposure draft for its Leases Project is due by the second half of 2012.