

Proposed changes to the accounting for leases could significantly impact balance sheets and affect debt covenant calculations.

On August 17, 2010, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) (together, the Boards) in an early effort at convergence, published an exposure draft related to proposed changes for accounting for lease contracts. The proposed changes, if adopted, are intended to improve the financial reporting information available to investors about the financial effects of lease contracts. While the changes are expected to have a significant impact on public entities, there will be impacts for private entities as well related to reporting and impact on financial ratios and debt covenant calculations.

Currently, the accounting treatment for leases is dependent on the classification of a lease as operating or capital. Operating leases are disclosed in the financial statements but not reported on the statement of financial position (balance sheet). Capital leases are both reported on the balance sheet and disclosed in the financial statements.

The proposed changes would result in a consistent approach to lease accounting for both lessees and lessors by using a “right-of-use” approach and no longer distinguishing, with different treatment, between a capital and an operating lease.

The changes would impact nearly all types of leases with few exceptions.

Impact for lessors

A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset would either:

- recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or
- derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). Under this approach the value of the asset would be reduced for the portion of the asset that is considered transferred to the lessee and the lessor would be considered to have no future risk or benefit from the asset (for example, the leased item would not be able to be re-leased or sold, therefore not expected to generate additional opportunity for income or reward).

The liability to be recognized would be valued at the present value of the lease payments which can be discounted using an incremental borrowing rate. The asset to be recognized would be equal to the amount of the liability plus any additional indirect costs incurred.

Expected changes in lease accounting could mean that the copier you use every day or the forklift and other equipment in the warehouse may have to be recognized on your Company balance sheet as an asset and liability. These items have likely never before been recorded on the financial statements but will now require initial recognition and measurement.



Impact for lessees

A lessee would recognize a liability for the present value of payments arising under the lease contract and an asset for the right to use included in the lessee's balance sheet. For many entities this could mean the recognition of debt which has never before been recorded on the balance sheet, but previously only discussed as an operating lease commitment in the footnotes. The additional debt on the entity's balance sheet could give rise to issues when evaluating compliance with debt covenants and the entity's ability to obtain financing.

Leases with a less than 12 month commitment

For leases of 12 months or less, lessees and lessors would be able to apply simplified requirements. There would still be a requirement to recognize the right to use asset and corresponding liability on the balance sheet but the amount to be recognized would be based on the gross amounts payable.

Timing

The Boards are accepting comments on the proposed changes through December 15.

The changes, if adopted, could go into effect as early as 2012.

