Ross Roundtable

On

The Biggest Change in Accounting Rules Ever: Proposed Global Standard on Accounting for Leases

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Research Reporter, Claire Eckstein

The Roundtable theme, lease accounting, is a controversial topic that has been raging for well over two decades; the battle continues on into the 21st century. Experts from the financial sector, entrepreneurs, regulatory agencies, credit-rating agencies, academe, and the accounting profession were invited to join the discussion with the objective of hearing "*all sides of the story*". For many years the Ross Institute Roundtables have successfully generated public dialogue, engaging in topics that benefit many sectors of society. Professor Paul Zarowin, Director of the Ross Institute and moderator of the panel, provided the opening remarks. Professor Zarowin welcomed the participants to what promised to be an interesting discussion on a *first tier* issue of major import to all sectors of the economy. To set the foundation for the discussion, highlights of the current and proposed models and controversy follow:

The current model:

- Operating lease: Lease expense is treated as an operating expense and the asset and liability are not recorded on the balance sheet. The lessor transfers only the *right to use* the property to the lessee.
- Capital lease: The lessee recognizes both an asset and a liability on the balance sheet. The present value of the lease expense is treated as debt, and imputed interest is reported on the income statement.

The 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 proposed model—Right of Use (ROU) redefined:

Danielle Zeyhar (FASB, Project Manager): Danielle presented highlights of the current model's definition of right of use, ROU.

- Leases will be determined as to whether a lease is effectively an installment purchase by the lessee. Under this approach, a lessee would account for most existing capital/finance leases as Type A leases, and operating leases as Type B leases. All leases for periods of less than one year will be recorded as operating leases.
- Lessee would recognize amortization of the *right-of-use* of an asset separately from interest on the lease liability.
- Operating leases, Type B leases, would recognize a single total lease expense on the income statement.

The ROU model gives the lessee the right to use an underlying asset. In return the lessee will submit payments to the lessor. The FASB definition is that a contract gives the right to use an asset for a limited time in exchange for a consideration. We have defined a lease contract with an identified asset and the right to control the use of that asset during the lease term. Capital leases will be accounted for similar to how they are

accounted for today. The main change in the new standard is in putting ROU leases on the balance sheet. Straight line lease expense will be reported on the income statement for operating leases. "If you look at the income statement today and you look at the income statement and statement of cash flows after the new standard, you should not see much of a difference". The only significant change to the lessor model will be relative to consistent alignment of the terminology used by the lessee and lessor ...and alignment with the new revenue recognition standard". In response to the concerns the FASB received in their outreach efforts-- major efforts were made to reduce the burden of preparers while preserving the usefulness of the information.

The controversy:

- The capitalization of all leases (exceeding 12 months) will cause key financial ratios to change: Long-term debt-to-equity will deteriorate causing loan covenants to be in default.
- Higher debt may cause increases in FDIC assessment rates for lending institutions—what will the economic impact be for both lender and borrower?
- EBITDA may be higher, since part of leasing costs will now be reported in interest and amortization, instead of just being an operating cost.
- Huge costs will be incurred by virtually all companies that comply with GAAP to prepare their financial statements. Do the benefits of the new standard outweigh the costs?
- Will the new standard change the way business is done? Will short-term leases replace long-term leases and how will this affect, in particular, real estate property values and the risk profile of investments?
- Lease expense will be presented in 3 different sections on income statement and 2 different sections on cash flow statement. The new presentation will invariably create confusion for users.
- The standard would require continuous reassessment of each lease when there is no change other than a change in an index. Not only would this be prohibitively costly, but it distorts the underlying economics of the transaction. Given that the unit of accounting is at each individual contract level, thousands of contracts would have to be changed. [In response to an outpouring of concerns these issues have been resolved. There will be no reassessment unless there is an underlying economic change. The unit of accounting at the individual level has also been modified.]

Viewpoints of preparers:

Chad Soares (Partner, PwC): The new standard has introduced opportunities and complexities. Big ticket items are really complex. Clients want to build an asset that upon completion will be an operating lease. They do not want to be the owner of the asset, but the accounting is so complex that they are uncertain about the outcome. If you don't get the negotiation just right, once it is on your books you evaluate under a different set of standards that can preclude you from taking if off your books once construction is over. If a client gets something wrong, it is a difference between a $50 million asset on the books and nothing during construction. Well-meaning thoughtful people may find themselves in default of covenants.

The title of the Roundtable "The Biggest Change in Accounting Rules Ever" was criticized by many.[1] If one considers the sheer volume of leases, and the fact that it is difficult to find any company, in any industry, that does not engage in leasing—the *biggest change* may not be an over statement. Lease contracts are not only

[1] In response to the critics, it was noted that a"?" was omitted in the title in error.

ubiquitous, but the economics underlying these contracts are as diverse as they are widespread. PwC believes that the sheer volume of these leases and the different economics underlying the leases should be more flexible to portray the underlying economics. The standard must be sufficiently flexible to distinguish between e.g. the underlying economics of a 5-year lease of a facility and a 30- year lease of an airplane.

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Neri Bukspan (Partner, Financial Accounting Advisory Services, Ernst & Young LLP): In recognition of the multitude of views on what constitutes a lease and a host of other issues, our firm provides analysts with raw data for their analytical models. Given the consensus that there are no "one size fits all" accounting standards or analytical models—is the discussion over "*accounting purity versus economic purity*" a play on words? Not really. Although there are countless viewpoints, no one can argue that, bottom line, being *practical*--the actual doing of something as opposed to theory-- is the key to transforming "purity" into "practice".

The calculation of the net present value (NPV) of e.g. 40,000 assets will at some point require a tradeoff between --"accounting and economic purity"—practice and theory—and timely preparation of financial reports. There are many who disagree with the compromises that must be made. We should give pause to the fact that although this Roundtable was promoted as the "Joint Project with the IASB", the IASB has thus far not been mentioned by either the presenters or the participants. At this time significant differences still exist and international investors will find the differences in reporting and analyses of the results challenging and time consuming. When a new standard is promulgated, an additional layer of scrutiny by auditors of procedures and internal controls is superimposed on the transition process. Although disagreement exists in many areas—there is one pervasive voice amongst industries—the costs will exceed the benefits.

Viewpoints of financial institutions:

Michael L. Gullette (VP, Financial & Accounting Management, American Bankers Association): The proposed standard will make it more difficult for analysts to have the data required to make their adjustments. This raises the questions we have: What are the incremental benefits? Will the new standard change business decisions? Is there evidence supporting the forecast that implementing the standard will result in a loss of 3 million jobs?

Bankers are not stupid and have been accounting for off-balance sheet financing leases. Financial statement ratios will change. However, bankers exist to work with borrowers and looking for technical defaults that lead to foreclosures is not in their best interest. The cost-benefit analysis for small companies is a major concern and should not be overlooked. It is imperative that the FASB Private Company Council become involved. The financial statements of all industries subject to FDIC regulatory requirements will be affected. A cost-benefit analysis under the new standard makes it highly unlikely that the banking industry will participate in the market for leveraged leases.

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John Bober (Managing Director, Global Technical Controller, GE Capital, representing Financial Executives International): Our analysis of an accounting standard from an industry perspective begins with scope-- the "population" we serve. In order to implement the new standard while serving our clientele, we have to be provided with clearly defined specifications that delineate a service contract and a lease. The guidelines that determine if transactions will be recognized on the balance sheet or the income statement should be *comprehensible*, and provide us with a basis for determining the monetary impact of recognition and costs of implementation.

It is important to take note of the fact that leasing is not an accounting construct. It is a business transaction that in general involves none-core generic assets best owned by specialized management. It is a practical, economical arrangement that has tax benefits.

Real estate leases provide an example of *bulk* In terms of dollar amounts; whereas the leasing of cars provides an example of large numbers of leases of small-ticket items. There is no need to prepare a spreadsheet to calculate a cost-benefit analysis of implementing the standard for small-ticket items. The sheer volume of leases with average values of under $30,000 provide a self-evident answer—the costs would far outweigh the benefits. The FASB responded and modifications were made that served to alleviate some of our major concerns. However, concurrent implementation of the revenue recognition, financial instruments, and lease obligations standards remains overwhelming.

Viewpoints from financial analysts and academe:

Martin Fridson (CFA, Chief Investment Officer, Lehmann Livian Fridson Advisors LLC): What are the implications of accounting for leases under the new standard for the syndicated loan market? Will the capitalization of leases alter the pricing of debt? If the market is efficient—the answer is straight forward—there will be no change. The lease liabilities and cash flows, whether disclosed in the footnotes or reported on the financial statements, are fully reflected in *pricing.* A change in where information is reported on the financial reports does not change the risk profile of the company. However, covenants that place limits on debt using measures of EBITA, debt ratios, etc. may place firms in technical default, thus creating a potential to be forced into bankruptcy by their creditors. However, this is a highly unlikely scenario. Because:

- Frozen GAAP: Tests for covenants are determined by the GAAP that was in place when the loan was made.
- Most loans incorporate the concept of semi-frozen GAAP and both parties are required to renegotiate in good faith when a breach occurs as a result of an accounting change.
- Under New York law it is unlikely that a technical default would push a company into Chapter 11.

Bond indentures may contain debt limitations. An accounting change that increases a firm's debt can potentially have a significant impact on a firm's ability to borrow. Although reporting lease liabilities could put firms in violation of debt ratios, it would not lead to default.

Interesting scenarios for speculation: Could activist investors use a breach created by a new accounting standard to force a company into bankruptcy? This could be a way to get a payout in full on secured debt. This strategy could also be used to gain control of a company by forcing out the equity owners and becoming the owners as the holders of the debt. It would be a "one-time" *coup* as anyone who tried this tactic would be blackballed.

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Aswath Damodaron (Professor, NYU): Leases are debt; there is nothing to debate. Accounting has one role; to supply me with the raw data. Capitalizing leases will be taking away the raw data I need to do things right. The market already knows the information; nothing is going to change. I wish digress and comment on the broader of issue of fair value: It is "***fair price"*** accounting; we mistake price for value and value for price.

In response to: What about covenants that are written in "frozen" accounting numbers? "Lenders that write covenants excluding lease payments as debt… credit rating agencies that ignore lease payments… and market participants that do not factor in the weight of lease payments…deserve to be taken to the cleaners."

The FASB:

Tom Linsmeier (FASB Member of the Board): If airlines have no airplanes on the balance sheet, or off shore drilling companies have no oil rigs on the balance sheet and neither has corresponding liabilities, it is not remotely possible to have representation of the assets and liabilities of the company. Perhaps less dramatic, but

equally important, are leases for fleets of vehicles, iPads, cell phones etc. that aggregate to material amounts but are un-accounted for and are not priced in the market. Additionally, our research provides evidence that the adjustments that analysts and preparers have been making for rent expense do not come close to their net present value.

If a lease provides you with all the risks and rewards of an asset, it should be accounted for as such. I have come to the conclusion that leased assets and liabilities are unique, and have benefits other than ownership. Leases are different than purchases and they deserve different accounting.

We are never going to succeed in providing the numbers that serve everyone in general purpose financial statements. Hopefully, with enough qualitative and quantitative disclosures, we are able to provide the data needed for adjustments that people want to make. Processing all these contracts will be costly but will ultimately lead to better pricing decisions from treasury.

Discussion Points

"The new standard is an odd compromise…. the future income and cash flow statement impacts are as if the firm was renting the asset rather than buying the asset financed with a loan. The balance sheet will tell one story while the income and cash flow statements will tell ...a different and inconsistent story. There is no precedent for this in the current accounting standards." Dan Gode (Prof. NYU)

"When you bring debt on the balance and you don't clean up the rest of the stuff you end up with the worst scenario of both worlds; the numbers do not match each other. You have income and cash flow statements at war with the balance sheet." Aswath Damodaran

"I think it is naïve to say you can reverse everything. If you are looking at the financial statements...you have type A (capital) and type B (operating) leases. … those who need to look at interest expense that is type A in theory… will have information that is actually going to help them. Telling the FASB to create something that will fit my model is not reasonable…people are getting paid to analyze financial statements." Neri Bukspan

- Replacement of existing software will be time consuming and costly.
- Many companies do not have automated systems tracking their operating leases.
- This is much more than a change in an accounting standard; it is as much a control of systems and processes as it is an accounting change.
- Companies with global operations have contracts that are not only written in different languages, but have different controls.
- How will the new standard effect the way operating leases are currently priced? The lessee is giving up tax benefits; are there going to be underlying changes?
- Lessee: "The change is so complex—we may just decide to buy the asset.
- There was a lack of consensus as to whether short-term leases will replace long-term leases and affect the risk profile of investments.

The decision to lease versus buy is first and foremost based on comparing the economic benefits thereof. The factors that should be considered when making this decision have been the subject of best-selling books, scholarly publications, as well as prestigious business conferences and workshops. And yet, the accounting recognition of this business construct has increasingly overshadowed, and to some extent had an effect, on the lease versus buy decision. What was noteworthy, as well as praise worthy, was the Roundtable discussion focused on issues of *representational faithfulness; substance over form:*

The relevant and reliable recognition of leases, while maintaining the pervasive constraints that the "*benefits* should exceed the *costs"* of compliance with complex accounting rules.