AN ANALYSIS OF THE IMPACT ON LESSEES OF THE NEW APPROACH TO LEASE ACCOUNTING

by William Bosco

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are reviewing a new approach to lessee lease accounting. The proposed lease standard will affect all companies since virtually all companies lease assets – some more than others for various reasons. This paper will examine the impact of the new approach on subsequent accounting for lease costs as compared to current GAAP (straight line rent expense for operating leases).

The proposed rule will capitalize the former operating leases which are currently not reported on balance sheet for lessees. The new approach creates a large non-cash expense, in which the amortization of the right of use (ROU) capitalized lease asset plus the recognition of imputed interest expense on the capitalized lease obligation exceeds the cash paid for rent in the first half of the lease term. It is a timing difference in which the lease expense is higher than the cash rent paid in the first half of the lease, but the pattern "turns around" in the second half of the lease where lease cost is lower than cash rent paid.

To determine the impact, the proposed new approach was examined by capitalizing existing operating lease obligations reported in the footnotes of 20 of the largest U.S. retail companies, transportation companies, banks and utilities. Estimates of contingent rents or options were not included, so the results are perhaps an understated view of the impact of the transition to the new rules. It was necessary to estimate the dispersion of operating lease cash flows after year five so the S&P approach was used (S&P assumes the thereafter amount is spread at the same rate as the five-year amount) to spread the number reported as "thereafter" in the operating lease obligations footnote disclosure.

The following calculations were made:

- The increase in lease cost over current GAAP in the first year of transition in millions of dollars and as a percent of lease cost under current GAAP (straight line cost).
- The cumulative increase in cost to the year of turnaround (when new total lease costs are less than straight line) and how many years it took for the cost difference to turn around.

The results of this analysis are as follows (results are in $ millions):

Company	Cumulative increase in lease cost in excess of straight line to turn around point	Year of turn around	First year increase in lease cost vs. straight line	% in excess of straight line cash expense in the first year

Walgreen's	2,664	10	456	23
CVS	1,500	9	330	19
Wal-Mart	838	8	194	17
Home Depot	581	9	125	16
Target	487	15	50	21
Sears	374	6	118	14
Kroger	323	6	112	14
Best Buy	275	6	127	12
Delta A/L	298	7	110	10
United A/L	303	7	149	11
Cont A/L	777	7	223	16
American A/L	498	7	146	15
US Air	624	7	285	11
FEDEX	632	7	211	12
BNSF	437	7	117	19
Bank America	913	6	305	13
JP Morgan	891	7	269	16
Citigroup	319	4	157	11
Exelon	98	9	21	16
AEP	178	7	55	18

The companies with real estate leases like retail companies and banks are hit the hardest since real estate leases tend to have longer terms (another capital hit for banks). Transportation companies are hit hard because planes and rail equipment typically have long lease terms and these companies also have real estate leases. The longer the average lease term the greater the impact of the front ending of lease costs. In a three-year lease, the first-year lease cost is higher than straight line by 7 percent and the cost difference turns around in one and a half years. In a 10-year lease, the first-year lease cost is 21 percent higher. The non-cash increased lease costs accumulate to a whopping 64 percent by year five (the half way point on the lease term). It then turns around over the last half of the lease term.

The above results do not include estimates of the impact of new leases. As new leases are entered into they will exacerbate the phenomenon as the amount of cumulative increased lease costs will grow and the year of turnaround will be pushed out further into the future. It should be noted that the phenomenon never really "turns around" for a going concern as new leases replace old leases. It will be a permanent charge to equity. It appears inevitable that companies will increase prices to make up for the increased lease costs caused by the new rules. The result could be another setback for the fragile worldwide economic recovery.

The phenomenon of non-cash expenses exceeding cash expenses will also create large deferred tax balances. In the United States, companies typically have a composite income tax rate of about 40 percent. This means that Walgreen's will have a deferred tax receivable that will exceed $1 billion in 10 years. For a going concern, the deferred tax receivable will be permanent as well. These impacts are huge.

Commercial real estate lessors fear that lessees will push for shorter term leases without renewal options or contingent rents to minimize the non-cash lease costs. Since landlords raise financing by using the leases and value of the property as collateral, the amounts they can borrow in the future will diminish if lease terms in fact shorten up. This certainly can't help improve real estate prices. It appears inevitable that landlords will increase rent rates.

There is a failure to match accounting with economic reality in the proposed approaches taken by the FASB/IASB in the lease accounting project. All this can be avoided if the FASB/IASB revisit subsequent accounting for leases to make it match the economics and eliminate the huge non-cash costs that will build up. However, without significant comments from lessees, they will not change their approach. The U.S. Securities and Exchange Commission should also be aware of the magnitude of the distortions created by the FASB/IASB's approach to cost accounting for leases.

The FASB/IASB proposed approaches to lessee and lessor accounting go far beyond just capitalizing operating leases on the lessee's books. No one quarrels with the fact that failure of lessees to capitalize operating leases is a major financial reporting deficiency. But neither has anyone said that rent expense was not the economically representative cost for operating leases.

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