lease accounting has an extremely lengthy and controversial history because it has been a major source of off-balance-sheet financing. In view of the many public outcries for increased transparency in financial reporting, it is no surprise that the accounting profession has intensified its interest in lease accounting. Given these longstanding concerns, it is remarkable that lease accounting has remained unchanged for more than a third of a century. This article briefly outlines the history of the debate and discusses the main provisions of a very significant proposed Accounting Standards Update (ASU) that has the potential to sharply curtail the current abuse of lease accounting as a means of obtaining off-balance-sheet financing.

The History
The problems with lease accounting are not new. In fact, the Committee on Accounting Procedure clearly identified the central problems when it issued Accounting Research Bulletin (ARB) No. 38, “Disclosure of Long-Term Leases in Financial Statements of Lessees,” in 1949.1 An effective resolution, however, has remained surprisingly elusive. Nearly 70 years have passed since that ARB was issued, yet little has changed regarding the basic premises at the heart of the debate. One of the most surprising aspects of this heated debate on leases may simply be the length of time it has taken the profession to

EXECUTIVE SUMMARY
Lease accounting has always been criticized as being a source for off-balance-sheet financing. A recent proposal, however, combats the misuse of leases by regulating capitalization, among other things.

Lease Accounting: Lessee
Provisions of the Proposed Accounting Standards Update

By Douglas M. Boyle, DBA, CMA, CPA; Brian W. Carpenter, Ph.D., CMA; and Daniel P. Mahoney, Ph.D., CPE, CPA
adopt measures to resolve the problem effectively.

To stem the growing occurrences of off-balance-sheet financing, in 2005 the Securities & Exchange Commission (SEC) issued its long-awaited report that called for changes in lease accounting standards. In 2006, both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) responded to these calls for action by placing the topic of lease accounting on their agendas.

The primary issues of contention in ARB No. 38 in 1949 were virtually identical to the issues the IASB and the FASB later identified in their lease Exposure Drafts they released jointly in August 2010 and May 2013. Likewise, the proposed solutions in these Exposure Drafts are remarkably similar to proposals in Accounting Research Study No. 4, “Reporting of Leases in Financial Statements,” released in 1962 by the American Institute of Certified Public Accountants (AICPA). Interestingly, the highly criticized provisions of Statement of Financial Accounting Standards (SFAS) No. 13, “Accounting for Leases,” which were put in place in 1976, were meant to curb lease accounting abuses that were associated with the then-existing standards as prescribed by Accounting Principles Board (APB) Opinion No. 5, “Reporting of Leases in Financial Statements of Lessee.” As was noted in 1996, it soon became clear that these provisions only served to “constrain, rather than end, the use of leases for off-balance sheet financing” as entities soon began structuring lease agreements to “fall just short of the cut-offs established by the FASB criteria.”

Fortunately, the Boards’ efforts over the years have culminated in Proposed Accounting Standards Update—Leases (Topic 842): A Revision of the 2010 Proposed FASB Accounting Standards Update, Leases (Topic 840), which would sharply curtail the potential for further misuse of lease agreements as a source of off-balance-sheet financing.

Main Provisions

The most noteworthy provision of the proposed ASU is the requirement that, with some limited exceptions, all leases having a duration of more than one year are to be capitalized. Currently, companies can report long-term leases as either capital or operating leases, depending on the lease contract’s specific terms. The criteria to make this determination have been increasingly criticized as “bright-line” accounting because of their precisely defined limits. The existence of these clearly delineated limits allows companies to structure leases in a manner that circumvents these specific bright lines and thus avoid recognition of the lease assets and associated lease liabilities that are inherent to capital lease arrangements. This ability to avoid recognition of lease assets and liabilities creates opportunities for the off-balance-sheet financing practices that fuel criticism of the existing guidance for lease accounting.

To address this problem, the current proposal would require the capitalization of nearly all leases having a duration of more than one year. Limited exceptions to this provision would exist for leases of intangible assets (Accounting Standards Codification® (ASC) Topic 350, Intangibles—Goodwill and Other), biological assets (ASC Topic 905, Agriculture), or leases involving exploration for, or use of, nonrenewable resources, such as minerals, oil, and natural gas (ASC Topic 930, Extractive Activities—Mining, and ASC Topic 932, Extractive Activities—Oil and Gas). These changes would limit operating leases to one year or less. The restrictions would greatly diminish the frequency and monetary value of operating leases, which will, in turn, sharply curtail the potential for abusing operating leases as a means of obtaining off-balance-sheet financing.

Expense Recognition Patterns

To address concerns regarding the impact that a transition from operating to capital lease accounting would have on the resulting expense recognition pattern, the proposal provides two types of capital leases, each with a different expense recognition pattern. The core issue regarding expense recognition patterns derives from the fact that operating leases are commonly associated with relatively even amounts of lease expense over time, typically equal to the periodic lease payments. Thus operating leases are typically associated with straight-line expense patterns that have relatively equal expense recognized in each period of the asset’s lease term.

In contrast, the expense recognition patterns typically associated with capital leases are usually front heavy, recognizing more expense in the earlier years of the lease
This front-heavy pattern associated with capital leases is a product of the two primary sources of recognized lease expenses for capital leases: the amortization of the leased asset and the interest expense resulting from the amortization of the associated lease liability.

Companies typically recognize the amortization of the leased asset on a straight-line basis while recognizing the amortization of the related lease liability through the use of the effective interest method. It is this latter component of traditional capital lease expense that causes the front-loaded expense pattern associated with current accounting for capital leases. This front loading of capital lease expense fuels some concern whenever proposals call for any shift away from operating lease accounting toward capital lease accounting. This concern affords opponents of such shifts in accounting practice the opportunity to cite this altered expense pattern as a reason to resist proposals like the current one, which shifts lease accounting toward the capitalization of lease agreements.

To address these concerns, the Boards have proposed the creation of two classes of capital leases, referred to as Type A and Type B leases. Type A leases would consume a significant portion of the leased asset, while Type B capital leases would be for leases that do not consume a significant portion of the leased asset. The determining factor in distinguishing between these two different classes will be whether the leased asset is property (i.e., land, buildings, or portions of buildings). Type A leases would be associated with nonproperty leases (i.e., aircraft, trucks, automobiles), and Type B leases would be associated with property leases.

The accounting for Type A capital leases would be much the same as the previous requirements for capital leases: recognition of both a leased asset and an associated lease liability as well as front-loaded expense patterns resulting from the combination of typically straight-line amortization of the leased asset and the effective interest amortization of the lease liability. The exercise price of a purchase option if the lessee has significant economic incentive to exercise the option; and the amount payable by the lessee under residual value guarantees.

Lease Payments, Initial Indirect Lease Costs, and Discount Rates
The provisions of the proposed ASU (see Table 1) specify that lessee lease payments would include:

- Lease payments, less any incentives received or receivable from the lessor;
- Variable lease payments that depend on an index or rate or are in-substance fixed payments;
- The exercise price of a purchase option if the lessee has significant economic incentive to exercise the option;
- Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease; and
- Amounts payable by the lessee under residual value guarantees.
Table 1. Main Provisions of the Proposed ASU on Leases

<table>
<thead>
<tr>
<th></th>
<th>Type A Capital Leases</th>
<th>Type B Capital Leases</th>
<th>Operating Leases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Criteria for Classification</td>
<td>Nonproperty leases of a duration greater than one year.</td>
<td>Property leases of a duration greater than one year.</td>
<td>Available as an elected, simplified procedure available for leases of a duration of one year or less.</td>
</tr>
<tr>
<td></td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td></td>
</tr>
<tr>
<td>Right-of-Use Asset</td>
<td>Equal to the present value of the lease payments plus initial direct lease costs.</td>
<td>Equal to the present value of the lease payments plus initial direct lease costs.</td>
<td>None recognized.</td>
</tr>
<tr>
<td></td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td></td>
</tr>
<tr>
<td>Lease Liability</td>
<td>Equal to the present value of the lease payments.</td>
<td>Equal to the present value of the lease payments.</td>
<td>None recognized.</td>
</tr>
<tr>
<td></td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td></td>
</tr>
<tr>
<td>Lease Expense</td>
<td>Amortization expense from the amortization of the right-of-use asset, amortized on a straight-line basis unless another systematic pattern better matches the asset's pattern of consumption.</td>
<td>The total projected amortization expense for the right-of-use asset will be combined with the total projected amount of interest expense for the lease liability. This combined amount will be recognized on a straight-line basis over the life of the lease term.</td>
<td>Equal to the amount of periodic lease payments. Expense will tend to be even throughout the lease term.</td>
</tr>
<tr>
<td></td>
<td>Interest expense from the amortization of the lease liability, using the effective interest method.</td>
<td>Expense will tend to be even throughout the lease term.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The amortization of the lease asset will be reported separately from the interest expense as a result of the amortization of the lease liability.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Expense will tend to be front loaded.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease Term</td>
<td>Required for lease terms greater than one year.</td>
<td>Required for lease terms greater than one year.</td>
<td>Available as an elective option for lease terms of one year or less.</td>
</tr>
<tr>
<td></td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td>Available as an elective option for lease terms of one year or less.</td>
<td></td>
</tr>
<tr>
<td>Potential for Off-Balance-Sheet Financing</td>
<td>None.</td>
<td>None.</td>
<td>Greatly constrained by the short duration and, thus, the lesser values associated with leases of a duration of one year or less.</td>
</tr>
</tbody>
</table>
The FASB and the IASB also specify that a company would capitalize initial direct costs, such as those attributable to negotiating and arranging a lease, and make them part of the carrying value of the right-of-use asset. These initial direct costs would include costs such as legal fees, commissions, closing costs, and the costs of preparing and processing documents. The Boards also listed particular costs that companies should not consider initial direct costs and thus should not capitalize as part of the right-of-use asset. Prohibited costs include general overhead, such as rent or depreciation, costs of unsuccessful origination efforts, and idle time. The Boards further propose that the lessee’s discount rate should be the lessor’s implicit rate if known to the lessee or the lessee’s incremental borrowing rate if the lessee does not know the lessor’s implicit rate.

**Lease Term**
The proposed ASU defines the lease term as the non-cancelable period of the lease, modified by possible lessee options to extend or terminate the lease. A company would make the determination based on whether the lease term should include such options on the lessee’s economic incentive to exercise the option. According to the proposed ASU, a company would make this determination at the commencement date and would consider contract-based, asset-based, entity-based, and market-based factors. This would clearly require considerable judgment in making this determination. As the Boards noted, a company would consider these factors in combination, and the existence of any of these factors alone would not necessarily indicate that the lessee has the incentive to exercise or not exercise the option. Future reconsiderations of this determination would be made only if there were changes in the noted factors that would change the previous determination or if the lessee actually chooses to exercise or not exercise an option in contrast to a previous determination.

**Valuation of Right-of-Use Assets and Associated Lease Liabilities**
Once the lessee determines the lease term, lease payments, initial direct costs, and discount rate, he or she would use this information to determine the initial value of the right-of-use asset and lease liability. The lessee’s lease payments over the duration of the lease term would be discounted by the appropriate rate to determine the present value of the lease liability. The valuation of the lessee’s right-of-use asset could differ from the liability’s present value because of the possible inclusion of any initial direct lease costs that the lessee may incur. If any direct lease costs exist, they would be added to the previously calculated present value of the lease payments to determine the amount to be recorded for the leased asset. As discussed earlier for Type A capital leases, a company would ordinarily amortize assets on a straight-line basis and liabilities on an effective interest basis. For Type B capital leases, a company will combine and recognize the anticipated amortization of both the lease asset and lease liability on a straight-line basis over the lease term.

**Potential Implications for Management**
Management may benefit from devoting a measure of time to assessing, anticipating, and communicating various effects possibly associated with the proposed changes. When enacted, the new requirements will likely increase the number of reported capital leases and, accordingly, will significantly affect the recognition of lease-related assets, liabilities, and expenses. If a firm must capitalize leases that it had previously reported as operating leases, this may affect certain key measures of profitability and solvency.

Accordingly, management would likely benefit from carefully examining whether they have leases that will be reclassified per the proposed requirements and, if so, carefully assessing the impact the changes may have on various balance sheet financial ratios. For example, the recognition of additional assets and liabilities that will accompany the reclassification of a lease from operating to capital can be expected to weaken the debt-to-equity and debt-to-total-assets ratios. In more extreme cases, an advanced awareness of these possible effects could potentially head off difficulties associated with debt covenants. Specifically, debt covenants related to debt-to-equity or debt-to-asset ratios may be affected and thus could potentially ignite concern on the part of creditors and shareholders—despite the fact the accounting changes will have no actual cash flow impact.
Because of this potential for undesirable financial ratio effects, organizations should consider telling key stakeholders about the changes and effects that these potential changes may have on the firm. If the firm expects adverse effects from the changes in lease accounting, it may be beneficial to inform key constituencies about this possibility in advance. To mitigate the potential negative fallout that might arise from changes in lease accounting, it is important to educate various stakeholders (i.e., stockholders and lenders) as to how these likely changes in lease accounting standards may potentially affect key measures of profitability and/or financial stability.

**Important Points and Expectations**

The most significant outcome resulting from the enactment of these proposed provisions would be a sharp increase in the number of leases required to be classified as capital leases and thus require the recognition of a right-of-use asset and associated lease liability. This would, in turn, greatly curtail the opportunities available for the abuse of lease accounting as a source of off-balance-sheet financing. The importance of capitalization to lease accounting is based on the fact that capitalization effectively eliminates the problems associated with lease-related off-balance-sheet financing.

Current accounting standards provide very clear criteria dictating when lessees must capitalize their leases. When capitalized, the lease-related assets and liabilities are recognized, thus precluding any form of off-balance-sheet financing. Unfortunately, the fact that these criteria are so clear makes it relatively easy for lessees to structure their lease contracts in a way to purposely avoid meeting any of the explicitly delineated criteria. The Boards termed this deficiency associated with this clarity of the criteria as “bright-line” accounting, metaphorically implying that the criteria are brightly defined lines that a company can easily circumvent. The proposed lessee accounting provisions would eliminate this possibility for all but short-term leases of one year or less. While this decision to potentially allow lessees to report short-term leases without such capitalization may look like backtracking, it more aptly represents a reasoned consideration of the costs and benefits of the Boards’ recommendations for lease accounting.

The proposed accounting would require capitalizing long-term leases that have the potential to materially affect the usefulness of the resulting financial statements. The proposed update would not require a company to capitalize short-term leases that are less likely to materially impact the financial statements, thereby lessening the accounting burden for lessees involved in short-term leases while still achieving goals the profession seeks.

The proposed accounting would create two classes of capitalized leases with different expense recognition patterns—Type A and Type B capital leases. Type A capital leases would be for leases that consume more than an insignificant amount of the leased asset’s benefits. Examples include nonproperty assets, such as equipment, trucks, or automobiles. Type B capital leases would be for leases that do not consume more than an insignificant amount of the leased asset’s benefits, including land, buildings, or portions of buildings.

Both classes of leases would recognize a right-of-use asset and an associated lease liability for future lease payments. The classes would differ mainly by their expense recognition patterns. Type A (nonproperty) leases would largely replicate treatment that previously was associated with capital leases recognizing two expenses: the amortization expense resulting from the amortization of the leased asset and the interest expense resulting from the amortization of the leased asset and the interest expense resulting from the amortization of the lease liability.

Because the interest amortization typically is based on the effective interest method of amortization, the combined expenses for Type A leases would tend to be front loaded with higher expenses in the earlier years of the lease term. The expense recognition techniques and patterns associated with Type B assets (i.e., property such as land or buildings) would differ from those associated with Type A assets. Type B leases would have an expense recognition pattern that would largely mirror operating leases in that expenses should be even throughout the lease term. The reason for this even pattern of expense recognition is purposeful because of the Boards’ requirements that the company should combine the total expense for both depreciation and interest amortization and then recognize it over the length of the lease term on a straight-line basis.

The only exception to this required capitalization
would be for short-term leases of one year or less where the lessee could elect to use a simpler method that would essentially replicate the current treatment used for operating leases. The most noteworthy aspects of such an election would be no recognition of a right-to-use asset or associated liability and that the expense would essentially be equal to the lease payments. Relief for short-term leases notably lessens the complexity of the proposed accounting with, at worst, only a limited opportunity for off-balance-sheet financing of any material amounts. The Boards’ stance seems to reflect a reasonable consideration of the standard’s cost-benefit consequences.

While the duration of the process that has led to the proposed ASU likely exceeded nearly everyone’s expectations, the proposals provide significant improvement in lease accounting that would greatly curtail a major source of off-balance-sheet financing and thus improve the transparency and quality of financial accounting reporting.

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Endnotes
7 The ASU stipulates that, for Type A capital leases, the right-of-use asset should be amortized on a straight-line basis unless some other systematic basis is more representative of the asset’s consumption.
8 The present value of the right-of-use asset could differ from the present value of the lease liability because of the possible inclusion of initial direct lease costs such as legal and administrative costs associated with obtaining the lease in the asset valuation. These initial direct lease costs are discussed later in the article.
9 The Boards further addressed the timing of recognizing lease assets and liabilities, specifically focusing on the dates of inception vs. commencement. They reconfirmed their decision to not require recognition of leases until the date of commencement. They further specified that the discount rate for the valuation would be the one applicable for the date of commencement.