Leasing Rules About to Get a Makeover

By Gregory T. Ivancic

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The accounting rules regarding the treatment of leases have been a hot topic since the mid-1970s. Back then companies were using affiliated entities to strip out income and recording large lease payments to increase expenses to reduce income and income taxes. The Statement of Financial Accounting Standards #13 issued in 1976 basically required that if a lease arrangement met certain criteria that the lessee was to record the leased property as if it was an asset. Those leases that met the criteria were known as capital leases. The criteria currently under the GAAP rules are that a lease will be classified as a capital lease if (i) the lease term is 75% of the expected economic life; (ii) ownership is transferred at the end of the lease; (iii) the lease permits a purchase at less than fair market value at the end of the term; and (iv) the present value of the lease payments is 90% or more than the fair market value when the lease is entered into.

The Financial Accounting Standards Board (FASB) and its international counterpart in 2006 began a joint project to examine the leasing issues for companies. New standards were drafted and comments were solicited, but the basic concepts of the original draft have remained the same without significant change. It now appears that the FASB is getting very close to issuing final standards.

Under the proposed standards, classifying leases requires a different set of criteria. The first is to determine if the transaction is a lease at all. In the typical lease arrangement this is fairly easy to meet since it only requires that the asset has to be described in the lease and the lessee must have control over the asset.   The second step is to identify if there is more than one component to the lease. The criteria here are that a part of the lease will be treated as a separate component if it provides benefits to the leasee on its own and is not highly integrated with the other parts of the lease. Think office building with a separate parking garage which under the proposed rules would be separate component. Lastly, the classification of the lease must be determined. Leases that are effectively installment purchases will be classified as "finance" leases. Those leases that don't necessarily fit in the finance category will be classified as operating leases. The difference from the current rules is that even if classified as an operating lease because the lessee uses the asset for an insignificant portion of the useful life and pays an insignificant portion of the fair market value, the lessee will still be required to capitalize the value of the lease and recognize a lease liability. Only those leases with extremely short terms (12 months or less, including renewals) will escape capital treatment and not be required to be shown as an asset on the lessee financial statements.

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