Financial Reporting Impact Of The Operating Lease Classification

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ABSTRACT

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are preparing to make changes to accounting standards for leasing that will have a significant impact on the financial statements of a large number of companies. The proposed standard will eliminate the "operating lease" classification, and if passed, companies using this classification will be required to report additional assets and liabilities on the balance sheet. This study estimates the impact of this change in accounting standards on the financial statements and several key financial ratios for an extensive sample of companies and industries from the Compustat North America database. It is important that users of financial statements understand and are prepared for these changes prior to implementation, particularly for industries in which operating leases are heavily utilized.

Keywords: Leasing; Capital Leases; Operating Leases; FASB; IASB; FAS Exposure Draft; Proposed Accounting Standards Update: Leases: Topic 840

INTRODUCTION

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are preparing to make changes to the accounting standards for leasing that will have a significant impact on the financial statements of a large number of companies. The proposed standard will eliminate the "operating lease" classification and companies using this classification will be required to report additional assets and liabilities on the balance sheet. This will result in a higher amount of reported debt, a higher debt to asset ratio, and a lower return on assets for many companies, even in the absence of any real economic changes to leasing transactions.

It is important that the users of financial statements understand the proposed changes and the effects they will have when implemented. This study estimates the impact of this change in accounting standards on financial statements and several key financial ratios for an extensive sample of companies and industries from the Compustat North America database. The estimation procedure is carried out using multiple discount rates, providing a range of the potential magnitude of this change.

CURRENT LEASING STANDARDS AND ISSUES

Under current U.S. accounting standards, leases can be classified as either "operating" or "capital" with very different financial reporting implications. The reporting differences are intended to reflect the economic difference between traditional rental agreements (operating leases) and financed purchases of assets (capital leases). Under the operating lease classification, lease payments are reported as rental expense for the lessee and rental revenue for the lessor, and no asset or liability is reported on the lessee's balance sheet. The capital lease classification requires the lessee to report the leased asset and a liability to make lease payments on the balance sheet, and corresponding depreciation and interest expense on the income statement. The lessor in a capital lease transaction derecognizes the leased asset and reports an asset representing both lease payments receivable and the expected residual value of the leased asset at the end of the lease term on the balance sheet, along with interest

revenue on the income statement. Classification of leases as operating or capital is determined by a "bright-line" test based on characteristics of the leased asset and the lease agreement[1]. International standards on leasing are very similar to U.S. standards with one important exception; while they use the same measures to distinguish between operating and capital[2] leases, the determination under international standards is based on economic significance rather than quantitative thresholds[3].

A number of concerns have been raised about current leasing standards, particularly for operating leases. The use of this classification is criticized on the grounds that even "true" operating leases or rental agreements give the lessee rights and obligations that meet the definition of assets and liabilities, and current standards force users to estimate these amounts without enough information to reliably do so. There are also concerns that the bright-line test used in the U.S. enables companies to manipulate lease terms to engage in transactions which in substance are financed asset purchases without reporting anything on the balance sheet – otherwise known as off-balance sheet financing. Accordingly, use of the bright-line test may lead to situations where very similar transactions are accounted for very differently.[i]

PROPOSED CHANGES TO LEASING STANDARDS

In July of 2006, the FASB and the IASB initiated a joint project to converge U.S. and international leasing standards while addressing concerns about the operating lease classification. After an extensive series of meetings, the issuance of a discussion paper, and solicitation of feedback, the FASB and IASB published an exposure draft of the proposed new standard in August of 2010. A revision of this exposure draft is projected to be released in the fourth half of 2013, and adoption of the new standard is expected to follow.

The proposed standard eliminates the operating lease classification and includes significant changes to the accounting model for both lessees and lessors. Lessees will be required to report a "right-of-use" asset and a liability to make lease payments on the balance sheet for all leased assets, regardless of the structure of the leasing arrangement[4]. Lessor accounting under the proposed standard varies depending on whether "significant risks or benefits associated with the underlying asset are retained." If so, lessors are to apply a "performance obligation" approach in which they report a liability representing the obligation to allow the lessee to use the underlying asset, as well as an asset for lease payments receivable. If significant risks or benefits are not retained, lessor accounting is similar to current treatment of capital leases with one exception – rather than derecognizing the entire leased asset, it is instead reduced to its residual value. The asset reported in this case represents only lease payments receivable[ii]. While the proposed standard includes many changes to lessee and lessor accounting, the biggest change will be the increase in assets and liabilities for lessees who are currently using the operating lease classification.

IMPACT OF THE PROPOSED CHANGE

While the changes proposed by the boards will affect the financial statements of both lessees and lessors, concerns about lessee accounting are what compelled the boards to make these changes. Lessees also represent a much broader group of companies and industries than lessors, and it is likely that users of lessors' financial statements will be more familiar with the proposed changes to leasing standards. For these reasons, we focus on the impact of the proposed standard on lessee accounting in this study.

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[1] A lease that meets any one of the following four criteria is considered a capital lease under current U.S. standards: i) Ownership of the asset is transferred to the lessee at the end of the lease term; ii) The lease contains a bargain purchase option; iii) The lease term is equal to 75% or more of the estimated economic life of the asset, or iv) The present value of the minimum lease payments at inception of the lease agreement is greater than or equal to 90% of the asset's fair value.

[2] Termed "finance" leases under international standards.

[3] Criteria related to transfer of ownership and bargain purchase are the same, but criteria related to the length of the lease term and present value of the lease payments are based on economic significance relative to the leased asset's economic life and fair value, respectively.

[4] The proposed standard makes an exception for leases with a maximum possible term of 12 months upon inception ("short-term" leases). Although it is not a requirement, the proposal allows both lessors and lessees to account for short-term leases in a way that is identical to accounting for operating leases under current standards.

We estimate the effect of the proposed change in leasing standards on the financial statements and financial ratios of lessees using a sample of 3,064 companies for which complete information regarding leases is available in the Compustat North America database for fiscal year 2010. Future minimum payments under operating leases are a required footnote disclosure under current U.S. standards. We calculate the present value of these amounts to estimate the increase in assets and liabilities that would result from implementation of the proposed standard[5]. Discount rates of 3%, 6%, and 9% are used in order to provide a range of the possible magnitude of the change. We report the effects of the proposed standard on lessees' total assets, total liabilities, debt to asset ratio, and return on assets ratio in Table 1. Table 2 presents the effects on our various metrics for the 15 industries in our sample that are most heavily impacted by operating lease capitalization.

Table 1
Changes in Selected Financial Measures Resulting from Operating Lease Capitalization

		Discount Rate		
	N	**3%**	**6%**	**9%**
Average % Increase in Total Assets				
Full Sample	3,064	11.09%	9.89%	8.91%
Total Assets > $25M	2,808	10.68%	9.48%	8.50%
Total Assets > $100M	2,513	10.54%	9.34%	8.36%
Average % Increase in Total Liabilities				
Full Sample	3,064	25.20%	22.53%	20.32%
Total Liabilities > $5M	2,891	24.21%	21.60%	19.44%
Total Liabilities > $100M	2,114	20.23%	17.94%	16.06%
Average % Increase in Debt-to-Assets				
Full Sample	3,064	10.68%	9.83%	9.09%
Total Assets > $25M	2,808	10.49%	9.64%	8.90%
Total Assets > $50M	2,678	10.12%	9.29%	8.57%
Average % Decrease in Return on Assets				
Net Income >$0	2,189	-7.35%	-6.75%	-6.23%
Total Assets > $10M/Net Income > $1M	2,121	-7.17%	-6.58%	-6.06%
Total Assets > $100M/Net Income > $10M	1,788	-6.91%	-6.33%	-5.82%

I. TOTAL ASSETS

The percentage increase in total assets is calculated for each company as the estimated increase in assets resulting from capitalizing operating leases divided by total assets as currently reported. The average of this estimate in our sample ranges from 8.91% (using a 9% discount rate) to 11.09% (using a 3% discount rate). The inclusion of companies with small amounts of total assets is likely to skew these averages upward. To address this issue, we also calculate the average increase in total assets for subsamples of companies with total assets greater than $25 million and $100 million. We find that the increase in total assets in these subsamples is only marginally smaller than the amount calculated using the full sample.

II. TOTAL LIABILITIES

The estimated increase in liabilities is divided by the company's reported liabilities to calculate the percentage increase in total liabilities. The average percentage increase in total liabilities for firms in our sample ranges from 20.29% (using a 9% discount rate) to 25.17% (using a 3% discount rate). Again, the average amounts are likely to be skewed upward by the presence of companies with small amounts of total liabilities, so we calculate the average percentage increase in liabilities using subsamples of companies with total liabilities of over $5 million

[5] We compiled information about operating lease payments for each of the next five years and for the period thereafter. To calculate the present value of these payments, we assumed that payments beyond year 5 would be equal to the average amount over the first 5 years until all dollars had been spent.

and over $100 million. Within these subsamples, the average increase in total liabilities is smaller than it is in the full sample, but still significant – the lowest average increase reported is 16.04%[6].

III. DEBT-TO-ASSET RATIO

The percentage increase in debt-to-assets is calculated by dividing the change in the debt-to-asset ratio (total liabilities divided by total assets) resulting from capitalization of operating leases by the current debt-to-asset ratio. The firms in our sample were estimated to have an average percentage increase in the debt-to-asset ratio between 9.09% (using a 9% discount rate) and 10.68% (using a 3% discount rate). To assess the sensitivity of these results to the presence of firms with small amounts of total assets, we calculate the average change in the debt-to-asset ratio for firms with total assets greater than $25 million and $50 million. The increase in the ratio for these subsamples is less than one percentage point below what is reported for the full sample, as seen in Table 1.

IV. RETURN ON ASSETS RATIO

Return on assets (ROA) is calculated as earnings excluding interest expense (net of tax) divided by total assets. We exclude interest expense from earnings to enable valid comparisons between firms that use debt financing and those that do not. To estimate the change in ROA that would result from the new standard, we estimate the "new" ROA to be 2010 net income (excluding after-tax interest expense) divided by the estimated value of total assets after operating leases are capitalized. This captures the initial impact on ROA after adoption of the new standard. The subsequent impact on ROA will also depend on changes in net income and total assets resulting from interest expense recognized on the lease liability and depreciation of the leased asset. We focus on the initial impact and therefore do not consider these effects. Since the denominator of the ratio (assets) increases and the numerator (earnings) remains the same, ROA decreases for firms with positive earnings and increases for firms reporting losses. In order to provide a meaningful average for change in ROA, we exclude firms reporting a net loss from our analysis. The estimated change in ROA is then divided by current ROA to compute the percentage change.

As reported in Table 1, the average percentage decrease in ROA for the sample ranges between 6.23% (using a 9% discount rate) and 7.35% (using a 3% discount rate). The change in ROA is likely to be larger if either net income or total assets is small. We test the sensitivity of our results to the presence of firms with these characteristics by calculating the average change in ROA for subsamples of firms with larger amounts of earnings and total assets. Two subsamples are analyzed; one includes firms with assets greater than $10 million and net income greater than $1 million, and the other includes firms with assets greater than $100 million and net income greater than $10 million. Although the average decrease in ROA is smaller in these subsamples, the difference is less than one percentage point.

V. INDUSTRY ANALYSIS

Table 2 reports average changes in our metrics for the 15 industries in our sample that are most heavily impacted by the proposed standard. To calculate the effect on specific industries, we partitioned the firms in our sample by 2-digit SIC codes, resulting in 68 distinct industries. The industries are selected based on the magnitude of the percentage change in total liabilities, but selection based on any of the other measures results in largely the same set of industries. As seen in Table 2, the "Apparel and Accessory Stores" industry suffers the largest impact of the proposed standard, with an average increase in total liabilities of 177%, an average percentage increase in debt-to-assets of 60%, and an average percentage decrease in ROA of 38%.

[6] This is the average increase in total assets estimated for companies with total liabilities greater than $100 million using a discount rate of 9% (Table 1).

Table 2[7]
Industries Most Affected by Capitalization of Operating Leases

Industry	Number of Firms	Average % Increase in Total Assets	Average % Increase in Total Liabilities	Average % Increase in Debt-to-Assets	Average % Decrease in Return on Assets
Apparel and Accessory Stores	46	73.30%	177.09%	60.59%	-38.37%
Educational Services	26	35.94%	105.75%	37.11%	-23.07%
Furniture and Equipment Stores	13	62.62%	104.33%	29.79%	-31.33%
Eating and Drinking Places	47	49.59%	95.67%	28.90%	-28.56%
Building Materials and Hardware	5	28.54%	94.87%	48.46%	-19.72%
Agricultural Services	1	28.94%	68.10%	30.37%	-22.44%
Food Stores	20	33.79%	66.77%	22.60%	-23.09%
Apparel and other Textile Products	28	23.43%	66.03%	31.83%	-15.15%
Miscellaneous Retail	58	8.37%	60.13%	18.77%	-19.24%
General merchandise stores	22	25.50%	59.54%	24.41%	-18.45%
Leather and leather products	13	19.43%	55.99%	28.82%	-15.91%
Auto Dealers and Gas Stations	20	31.13%	54.60%	16.31%	-16.91%
Health Services	57	26.50%	51.26%	15.20%	-13.43%
Social Services	6	29.07%	46.06%	11.46%	-28.00%
Transportation by Air	28	32.36%	45.99%	9.45%	-22.07%

CONCLUSION

If the proposed changes to leasing standards are passed, the impact on the financial statements and key financial ratios of lessees will be significant, and in many cases severe. It is important that users of financial statements understand the changes and are prepared prior to implementation, particularly for industries in which operating leases are heavily utilized. The effects of these changes will be far-reaching – from credit ratings to incentive compensation, modifications to current practice will have to be made to reflect the changes in accounting information that will result from the proposed elimination of the operating lease classification.

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ENDNOTES

[i] FAS Discussion Paper, "Leases: Preliminary Views"
[ii] FAS Exposure Draft, "Proposed Accounting Standards Update: Leases: Topic 840"

[7] All amounts reported are calculated using a discount rate of 6%.

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