INDUSTRY TOPICS:

The Proposed New Lease Accounting Standards

Last spring, the Financial Accounting Standards Board (FASB) issued its proposed Accounting Standards Update (Revised), Leases (Topic 842), a revision of its 2010 proposal on lease accounting standards. The proposed model is the latest in what has been a lengthy attempt to address the current standards' "… failing to meet the needs of users of financial statements because they do not always provide a faithful representation of leasing transactions," according to FASB.

What's Different?

For manufacturers and distributors, many of whom have significant leasing arrangements, the proposed standards would force them to include leases on their balance sheets as part of their overall debt obligations. The following is a recap of what is proposed.

Currently, generally accepted accounting principles (GAAP) distinguish between two types of leases: capital leases and operating leases. With the former, assets and liabilities are recorded on the balance sheet and the asset is depreciated, while the lease obligation is amortized over time as debt. With the latter, assets and liabilities are not recorded on the balance sheet, but lease payments are expensed on a straight-line basis. In other words, operating leases treat assets and liabilities as off-balance-sheet items.

The proposed standards would dramatically change the way leases are handled for accounting purposes. The theory behind the change, according to FASB, is that a company "should recognize assets and liabilities arising from a lease," which it deems an "improvement over existing lease requirements." Under the new standards, a lessee would recognize the net present value of lease payments as a liability and also recognize a "right to use" asset representing the lease payments due over the term of the lease, and related value of having access to the underlying property.

Potential Impact

For manufacturers and distributors, lease expenses are often the largest operating cost other than materials and payroll. By forcing manufacturers and distributors to recognize future liabilities for operating lease payments in their financial statements, these proposals will have a major impact on the balance sheet.

It all comes down to leverage. The requirement to record lease liabilities — and thus, long-term payment obligations — on the balance sheet will result in substantially more leverage being added to the balance sheet. This could then impact a manufacturer's or distributor's ability to meet loan covenants and agreements with its bank, including debt service coverage and financial leverage ratios, and could also affect a bank's calculation of tangible net worth.

Will They Be Adopted?

FASB has received hundreds of comment letters on the proposed new lease accounting standards from trade groups, companies and individuals all over the world. Many of the comments have been negative. During the first quarter of 2014, FASB and IASB once again began deliberations of the 2013 proposal, but they haven't made any firm decisions to date.

Since new lease accounting standards aren't likely to go into effect before 2017, there's plenty of time for next steps to unfold. We will keep you updated on new developments in future issues of this newsletter.

We hope you find this information valuable. As always, we are here to help and we love to talk about business improvement opportunities. Contact us to learn more about the new lease accounting standards proposal and how it might affect your business.

John E. Oeltjen, CPA
Shareholder | Director of Manufacturing & Distribution Services
joeltjen@muellerprost.com
314.862.2070

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