“One of my great ambitions before I die is to fly in an aircraft that is on an airline’s balance sheet,”
Sir David Tweedie, Former Chairman of the IASB, revealed during a speech to the Empire Club of Canada on April 25, 2008.

This month, the Financial Accounting Standards Board (FASB) reached the deadline for comment letters submitted to them in regard to their revised proposed Accounting Standards Update for Leases (Topic 842). The exposure draft was originally released in May 2013 as a revision to the 2010 proposed Accounting Standards Update (Topic 840). Much like the original proposal in 2010, the 2013 proposal has been met with stiff opposition from the accounting and financial industries. Before diving into each side of the debate, it would be sensible to start from the beginning: when the issues regarding leases were identified and brought to the attention of the business community.

The debate over the accounting of lease agreements actually began around this same time 10 years ago. In 2003, United Airways Group Inc. filed for Chapter 11 bankruptcy and brought attention to one particular bankruptcy law: in some particular cases, lessors can be treated as a secured creditor in court. On the 2003 audited financial statements, US Airways had $3.15 billion of long-term debt on their balance sheet; however, they had an additional $7.39 billion for operating leases disclosed in the notes of their financials for their large fleet of airplanes.1 In 2005, in response to US Airways, the Securities and Exchange Commission began efforts to ensure that publicly traded companies’ lease accounting was accurate and complete. As a result, approximately 270 companies had to restate their earnings.2

As many accountants are aware, according to GAAP, leases can fall into two categories, capital leases and operating leases, with capital leases being disclosed on the balance sheet and operating leases disclosed in the notes. In determining the category of the lease, it really comes down to two factors. If the present value of the minimum lease payments is equal to or greater than 90% of the leased asset or if the lease terms cover 75% of the useful life of the asset being leased, the lease is a capital lease. While these rules make it simple for accountants, does it really portray the economic substance of the company’s lease to the stakeholders? Do investors in a company really care about the terms of lease agreements? Maybe, but stakeholders are probably more interested in knowing how much the company would owe to lessors should something unforeseen happen. In that case, wouldn’t that make a lease agreement similar to a note payable?

This has been the issue that FASB has been attempting to address, specifically in regard to operating leases. Simply put, the FASB has proposed that companies move their operating leases greater than 12 months onto their balance sheet - similar to capital leases. The reason this has been the subject of such criticism is twofold. First, companies tend to like operating leases. Operating leases increase returns on assets ratios and generally don’t drag down earnings with additional depreciation expense. Secondly, determining the value of these leases would be difficult to calculate. Even the FASB’s own Investor Advisory Committee decided not to back the proposal, claiming it is not an improvement on the current accounting rules and that the costs of implementing the proposal would surpass the benefits.3

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1 US Airways Inc. 2003 Audited 10-K Financial Statements
3 Tysiak, Ken “Type A or Type B? Lease Concerns Emerge at Round Table.” The Journal of Accountancy. 23 Sept. 2013. Online.
While this debate seems to be centered on how this proposal will affect publicly traded companies, this proposal could have adverse affects on smaller businesses as well, particularly with financial institutions small businesses work with to keep their company operating. In theory, the added liability and the added assets should balance each other so the net worth of the company will not be affected. But most notes payables and line of credit agreements have covenants that use ratios tailored to the lender’s interest in the company. Notably, the debt coverage ratio, which is calculated as net operating income divided by total debt. If the proposal does become part of GAAP, banks and lenders will need to adjust their covenants to account for this additional liability or companies will have to adjust the way they do business in order to continue to receive financing. One thing appears certain though, the days of drafting leases in order to keep lease obligations off the balance sheet will soon be a thing of the past.