Capitalizing Lease Payments

Potential Effects of the FASB/IASB Plan

By Amanda M. Grossman and Steven D. Grossman

If the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issue a standard on accounting for leases that sharply curtails the suitable applicability of operating leases, many companies will be required to convert their operating leases to capital leases.

Such a conversion would have an effect on both current and total liabilities for companies currently reporting would-be capital leases as operating leases. Of the top 200 companies of the *Fortune* 500 list for 2009, 91 were chosen for study. Without discounting, 60 of the companies would have increased their current liabilities by less than 5%, but 21 would have increased them by at least 10%. With discounting, 70 of the companies would have effects of less than 5% for current liabilities, but 13 would have increases of at least 10%; for total liabilities, the effect was less than 5% for 50 companies but at least 10% for 29 companies. These increases could have important implications for financial analysis.

Lease Accounting Issues

In March 2009, FASB and the IASB issued a joint discussion paper, *Leases—Preliminary Views*, to address the problems inherent in lease accounting. Specifically, the discussion paper addresses the disparity in the treatment of lease contracts under U.S. GAAP and International Financial Reporting Standards (IFRS). Users have criticized FASB's current lease standard—Statement of Financial Accounting Standards (SFAS) 13, *Accounting for Leases*, now codified as Accounting Standards Codification (ASC) 840. Some argue that lessees are not properly reporting assets and liabilities on the balance sheet and that the financial statement notes are insufficient to adjust the provided lease information. Because FASB's standard allows for both capital and operating leases, transactions that are similar in form could be recognized differently, impairing comparability of financial data. In addition, lessees can ostensibly take advantage of the divergence in the standard by purposefully structuring leases as operating leases to avoid recognizing liabilities and engage in off–balance sheet financing.

The boards generally agreed that the IASB's standard (IAS 17, *Leases*), which is more principles-based, is superior to FASB's rules-based standard. The boards proposed, in their right-of-use model, that all leases give rise to obligations for the future rental payments and assets for the use rights contained in the lease contracts. All leases would thereby be accounted for in a consistent manner. The result would be more credible and transparent financial statements. The boards currently plan to issue an exposure draft of a new lease accounting standard closely mirroring IAS 17 in the second quarter of 2010 and implement a final standard in the second quarter of 2011. According to the discussion paper, the purpose of the standard is to unify the treatment such that all assets and liabilities arising from lease contracts are recognized on the balance sheet (statement of financial position).

FASB and IASB Lease Standards

A few key differences exist in the current lease accounting standards issued by FASB and the IASB. Currently, FASB's standard (SFAS 13) for capitalizing leases has four crite-

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ria, only one of which needs to be met by the lessee:

■ The lease contract provides for a transfer of ownership by the end of the term.

■ The lease contract contains a bargain purchase option.

■ The lease term is at least 75% of the asset's economic life.

■ The present value of the minimum lease payments is at least 90% of the asset's fair value.

The IASB's standard (IAS 17) for classifying a lease as a finance lease (capital lease under FASB's terminology) depends upon whether substantially all of the risks and rewards of ownership are transferred to the lessee. The standard includes the first two FASB criteria, but neither the 75% criterion nor the 90% criterion is used. Instead, the IASB's standard states, in part, that a lease is a finance lease if the lease term is for the major part of the asset's economic life or if the present value of the minimum lease payments equals substantially all of the fair value of the leased asset. A few other criteria (e.g., the asset can be used only by the lessee without major modifications) are also included in the IASB's standard.

The IASB's standard is reminiscent of Accounting Principles Board (APB) Opinion 5, *Reporting of Leases in Financial Statements of Lessee*, which looked to substance over form. If the lease is an installment purchase of the asset, the obligation and asset should be reported on the balance sheet. A noncancelable lease—in which the initial term is considerably less than the economic life of the asset but can be extended through bargain renewal options, or in which a bargain purchase option exists—usually establishes the supposition that the lease is in substance an acquisition of the asset, and should be capitalized.

EXHIBIT 1
Effects on Current Liabilities of 10% or More (Undiscounted)

Company	Industry	Increase
CVS Caremark	Drugstores	12.9%
Walgreens	Drugstores	27.7
Rite Aid	Drugstores	45.6
Kroger	Grocery stores	10.2
Safeway	Grocery stores	10.4
AMR (American Airlines)	Major airlines	10.6
Delta Air Lines	Major airlines	14.9
UAL (United Airlines)	Major airlines	18.5
Continental Airlines	Major airlines	33.0
McDonald's	Restaurants	41.2
Burlington Northern Santa Fe	Railroads	17.0
Union Pacific	Railroads	22.8
Staples	Specialty retailer, other	17.8
Office Depot	Specialty retailer, other	20.6
Best Buy	Electronics stores	13.0
Tesoro	Oil and gas refining	18.6
Anadarko Petroleum	Independent oil and gas	21.5
Nike	Footwear and accessories	10.1
Gap	Apparel stores	49.5
Kohl's	Department stores	24.5
Toys 'R' Us	Toy and hobby stores	22.6

Capitalizing Operating Leases

A sample of 91 nonfinancial companies that issued 2009 10-K reports was chosen from the top 200 of the *Fortune* 500. First, the increases in current liabilities from undiscounted lease payments were computed. The undiscounted lease payments include both the principal and interest to be paid. The undiscounted operating lease payment for the upcoming year was divided by the company's current liabilities to ascertain the percentage increase in current liabilities if the operating leases had been classified as capital leases. The effect was less than 5% for 60 of the companies and 10% or more for 21 of the companies (*Exhibit 1*).

The three largest percentage increases in current liabilities were Gap (49.5%), Rite Aid (45.6%), and McDonald's (41.2%). The assets leased by the industries represented in Exhibit 1 are delineated in *Exhibit 2*.

While calculating the effects on current liabilities using undiscounted lease payments yields some interesting comparables, using discounted lease payments provides a more accurate picture of the effect of capitalizing operating leases, because the current FASB and IFRS pronouncements require the present value of the capitalized lease payments to be reported on the balance sheet. To illustrate, the lease obligations note in Safeway's 2008 annual report displays minimum lease payments of capital leases for the five upcoming years (2009–2013) and thereafter, and a total of $1,037.3 million. The present value of these payments is shown as $557.2 million. Of this amount, $40.6 million, the present value of the 2009 payments of $94.3 million, is displayed in the note and listed under current liabilities on the balance sheet; $516.6 million is displayed in the note and listed under long-term debt on the balance sheet. Therefore, the lease payments should be discounted to convert operating lease payments to those of capital leases. Unfortunately, none of the companies provides a discount rate to use. Consequently, the utilization of discounted lease payments requires the derivation of an estimation technique.

The information for capital leases reported by the companies analyzed was used to estimate the present value of the operating

lease payments. First, the effect of capitalizing operating leases on total liabilities was examined. Of the companies examined, 32 reported capital leases as well as operating leases. The percentage of the present value of the minimum lease payments to the undiscounted minimum lease payments was computed for each company reporting capital leases; these ranged from 26% to 91%, with a median of 67%. Using the median value as an approximation for discounting purposes, each of the percentage increases in total liabilities for treating operating leases as capital leases was computed. For example, total minimum operating lease payments for Continental Airlines were $14,869 million. Multiplying that figure by 67% yielded $9,962 million; then, dividing that figure by the total liabilities of $12,581 million yielded 79.2%. The effect was less than 5% for 50 companies; for 29 companies, the effect was 10% or more.

Next, the effect of capitalizing operating leases on current liabilities was examined. Only 14 of the companies reporting capital leases disclosed the present value of the upcoming year's payment. The percentage of the present value to the undiscounted figure ranged from 18% to 78%, with a median of 58%. While some companies discounted the upcoming year's payment, many used the change in present value technique, whereby the discounted value is the amount by which the lease obligation will be reduced by the end of the upcoming year (the difference between the payment and the year's interest expense). Using the 58% as an approximation for discounting purposes, each of the percentage increases in current liabilities for treating operating leases as capital leases was computed. For example, the upcoming operating lease payments for Continental Airlines were $1,475 million. Using the 58%, the present value was $856 million. Then, dividing that amount by the current liabilities of $4,474 million yielded an increase of 19.1%. The effect was less than 5% for 70 companies and 10% or more for 13 companies. For 13 companies, the percentage increase for both current and total liabilities was 10% or more (*Exhibit 3*).

Ratio Effects

Even for those companies for which the impact on current and total liabilities was less than 5%, there still could be important implications for financial ratios. For example, if a company's current ratio equaled 1.0, a 5% increase in current liabilities would reduce the current ratio to 0.95. The effect on the debt-to-asset ratio or the debt-to-equity ratio requires an assumption as to the recognition of leased assets if operating leases were converted to capital leases. To ascertain the effect on the current ratio for the eight companies that disclosed leased assets for capitalized leases, the following steps were taken:

- The current ratio using current assets and current liabilities was computed.
- The current ratio, including current liabilities and the undiscounted upcoming year's operating lease payment, was computed.
- The current ratio, including current liabilities and the discounted upcoming year's operating lease payment, was computed.

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The discounted payment was calculated (as in Exhibit 3) by multiplying the upcoming year's operating lease payment by 58%.

The results are shown in *Exhibit 4*. Except for two of the eight companies, the inclusion of the upcoming operating lease payment either caused a significant decline in the current ratio or changed the current ratio from greater than one to less than one.

For the eight companies that disclosed leased assets for capitalized leases, the percentage of leased assets to lease obligations ranged from 35% to 172%, with a median of 83%. To discern the effect on the ratio of total liabilities to total assets, the following steps were taken:

- The ratio of total liabilities to total assets using the reported figures was computed.
- Using the 67% rate (as in Exhibit 3) to calculate the present value of the total operating lease payments, the leased assets corresponding to the capitalized operating lease payments were computed. For Chevron, the total operating lease payments of $2,888 million were multiplied by 67% to yield the present value of $1,935 million. Using the 83% rate, the leased assets corresponding to the $1,935 million liability equaled $1,606 million.
- The ratio of reported total liabilities plus discounted operating lease payments to total assets plus the now-capitalized leased assets was computed. For Chevron, the total liabilities plus discounted operating lease payments were $75,983 million ($74,048 million plus $1,935 million). The total assets plus the previously computed leased assets figure were $162,777 million ($161,165 million plus $1,606 million). The ratio equaled 0.47.

The results are shown in *Exhibit 5*. Except for Kohl's, the effect of including the capitalized operating lease payments in computing the ratio of total liabilities to total assets is not as significant as the effect on the current ratio, but it still might have important implications for financial analysis.

EXHIBIT 2
Leased Assets, by Industry

Industry	Leased Assets
Drugstores	Retail stores, distribution centers, equipment
Grocery stores	Stores
Major airlines	Aircraft, airport facilities (terminals, hangars, maintenance)
Railroads	Locomotives, freight cars, office buildings
Restaurants	Restaurant locations (land only or land and buildings)
Oil and gas	Drilling rig commitments, production platforms, buildings
Retail stores*	Retail stores, equipment, distribution centers

*Includes specialty retailers, electronic stores, footwear and accessories stores, apparel stores, department stores, and toy and hobby stores.

EXHIBIT 3
Increases in Current Liabilities and Total Liabilities of 10% or More (Discounted)

Company	Industry	Current Liabilities	Total Liabilities
Walgreens	Drugstores	16.1%	235.0%
Rite Aid	Drugstores	26.4	81.1
UAL (United Airlines)	Major airlines	10.7	32.2
Continental Airlines	Major airlines	19.1	79.2
McDonald's	Restaurants	23.9	44.8
Union Pacific	Railroads	13.2	16.3
Staples	Specialty retailer, other	10.3	51.9
Office Depot	Specialty retailer, other	11.9	52.7
Tesoro	Oil and gas refining	10.8	21.5
Anadarko Petroleum	Independent oil and gas	12.5	10.7
Gap	Apparel stores	28.7	99.0
Kohl's	Department stores	14.2	162.5
Toys 'R' Us	Toy and hobby stores	13.1	35.6

Income and Stockholders' Equity Effects

For operating leases, rent expense is reported on the income statement. For capital leases, interest expense and amortization expense are reported on the income statement. Any ratio in which income is included would be affected by operating leases treated as capital leases. Examples include return on assets and interest coverage.

As net income is closed to retained earnings at the end of an accounting period, stockholders' equity is also affected. Any ratio in which stockholders' equity is included would also be impacted. For example, the ratio of total liabilities to stockholders' equity can be calculated. Referring to the Chevron computations for Exhibit 5, the present value of the total operating lease payments was $1,935 million and the corresponding leased assets were $1,606 million. To balance, the stockholders' equity has to decrease by the difference, $329 million. Using the reported figures, the ratio of total liabilities to stockholders' equity is 0.85 ($74,048 million ÷ $87,117 million). If operating leases are capitalized, as depicted above, the ratio is 0.88 [($74,048 million + $1,935 million) ÷ ($87,117 million – $329 million)]. In this case, the resulting ratio would put Chevron in a worse liability position.

Implications

Under U.S. GAAP and IFRS, lessees may try to avoid capitalizing leases in order to circumvent reporting leased assets and obligations on the balance sheet. As FASB and the IASB discuss a better standard, it is interesting to examine the impact of capitalizing all operating leases on reported current and total liabilities. According to the data analyzed, requiring companies to display leased assets and corresponding liabilities for operating leases may significantly impact financial indicators.

While the present value of capital leases is reported in the financial statements, the present value of operating leases is not. A median percentage of the present value of capital leases to the undiscounted amount for those companies reporting capital leases is used in this article to convert operating leases to capital leases for all the companies examined. The use of a median percentage is a limitation of this study. It would have been preferable if each company reported the discounted value of its operating leases, but such information does not have to be provided. Nevertheless, the estimation technique yields a reasonable representation of the effect of capitalizing operating leases.

With the conclusion of the comment period on the boards' joint discussion paper, 290 letters were received by August 2009 and summarized on FASB's website. Approximately half of all respondents, agreed with the boards' right-of-use model, stating that the discretion between operating leases and finance (capital) leases is mostly arbitrary and creates unnecessary complexities. In addition, proponents claimed that this principles-based approach would reduce the opportunity for self-serving lease structuring. Interestingly, respondents who were users of financial statements were unanimously in favor of the boards' model.

In contrast, respondents who were against the boards' views claimed that the existing accounting model takes into consideration legitimate differences between operating and finance leases and that the cost to implement a new standard would outweigh any potential benefits. Critics of the right-of-use model claimed that even with the implementation of a principles-based standard, the purposeful restructuring of leases would remain a potential problem. In addition, the new model may negatively impact the leasing industry, as the complexity of standard requirements may cause lease contracts to be avoided, even if it would be beneficial.

Other potential drawbacks should also be considered if the boards decide to adopt the right-of-use model. While potentially improving consistency and transparency, the boards' tentative position to capitalize all or most operating leases could lead to new problems. For instance, with more debt on their balance sheets, companies may find obtaining financing more difficult. In addition, the reclassification of operating leases as capital leases would cause some companies to be in violation of debt covenants, which require strict debt ratios. Since the boards reaffirmed the right-of-use approach to lease accounting for lessees in December 2009, it will be interesting to see what, if any, future concessions are made. ❑

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EXHIBIT 4
Effect on Current Ratio from Including Upcoming Year's Operating Lease Payment

Company	Using Reported Figures	Including Undiscounted Payments	Including Discounted Payments
Chevron	1.14	1.12	1.13
Verizon Communications	1.01	0.95	0.98
Walt Disney	1.01	0.97	0.99
Rite Aid	1.90	1.30	1.50
Tesoro	1.14	0.96	1.03
AMR (American Airlines)	0.63	0.57	0.60
Goodyear Tire & Rubber	1.75	1.65	1.69
Kohl's	2.04	1.64	1.78

EXHIBIT 5
Effect on Ratio of Total Liabilities to Total Assets from Including Total Operating Lease Payments

Company	Using Reported Figures	Including Discounted Payments
Chevron	0.46	0.47
Verizon Communications	0.61	0.62
Walt Disney	0.46	0.48
Rite Aid	1.14	1.18
Tesoro	0.57	0.63
AMR (American Airlines)	1.17	1.13
Goodyear Tire & Rubber	0.93	0.95
Kohl's	0.41	0.69