**IS A LEASE ACCOUNTING BREAKTHROUGH IN THE OFFING?**

**WE ARE HOLDING OUR BREATH**

***Anthony H. Catanach Jr. and J. Edward Ketz***

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Emily Chasan wrote in *The CFO Journal* that a “[Lease Accounting Breakthrough Could Come in June](http://blogs.wsj.com/cfo/2012/05/24/lease-accounting-breakthrough-could-come-in-june/?mod=google_news_blog).” Since this issue has been debated for several decades, it is about time.

Chasan reports that “board members … still believe investors want to see lease obligations on corporate balance sheets to get a clearer picture of corporate liabilities.” Like duh!! Of course they do, because any reasonable person would readily admit that all lease obligations should be recognized. They are liabilities—and even intro accounting students know that liabilities go on the balance sheet.

That being said, [two California congressmen](http://bradsherman.house.gov/2012/05/congressman-sherman-and-congressman-campbell-lead-effort-to-stop-new-accounting-rules-for-leases.shtml) (who are actually CPAs) unbelievably oppose putting these debts on the balance sheet because of the “disastrous consequences” that presumably would ensue for American businesses. Didn’t we hear these same “the sky is falling” arguments for pension obligation and stock option accounting as well? Nevertheless, these two accountant-legislators either missed an accounting theory class along the way, or worry more about re-election than financial reporting transparency.

Back to the new lease proposals…a big point of contention at both the FASB and the IASB is how to amortize costs. One approach would use a present value approach, and the alternative would straight-line the costs. While we prefer the first as conceptually superior, the other method is also acceptable because it at least forces corporate America to recognize these debts in the financial statements instead of pretending that they do not exist. The second more simplistic approach also avoids yet another opportunity for managers to play with the numbers via discount rate and other present value assumptions.

Let’s restate the fundamental problem with present-day lease accounting. Issued in November 1976, Statement No. 13 still governs the accounting for lessees in the US. The statement invents two classes of leases: capital and operating. In a capital lease, the firm records an asset and an obligation for the leased property equal to the present value of the future cash flows specified in the lease agreement (not to exceed its fair value). Going forward, companies must report depreciation for the capitalized asset, as well as interest expense and principal payments for the lease obligation. In contrast, for operating leases, an entity completely ignores its property rights and obligations; the only thing it does is book rent expense.

Accounting for most operating lessees is ridiculous, absurd, contorted, distorted, and illogical. By allowing business enterprises to ignore the reality of some leases, and not to report the economic effects on the financial statements, the FASB and the IASB have been accessories to the accounting games played by corporate managers for decades.

Earlier this year we illustrated the magnitude of the problem by recasting the [financial statements of CVS](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/550) to disclose the effects of lease capitalization. (We also have illustrated the effects of lease capitalization on [Groupon](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/597) and [Zynga](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/581).) We employed the following adjustment process:

* Find the lease cash payments.
* Choose an appropriate rate of interest.
* Compute the leased assets and the lease obligations as the present value of the future cash payments.
* Estimate the life of the leased assets and their current age. With these assumptions, calculate depreciation expense and accumulated depreciation.
* Estimate the interest expense.
* Estimate the change in income taxes and deferred income taxes.
* With these adjustments, prepare the adjusted income statement and the adjusted balance sheet.

We carried out these steps for [CVS Caremark using its annual report for 2011](http://phx.corporate-ir.net/phoenix.zhtml?c=99533&p=irol-seccat2012) and obtained the following results (dollar amounts in millions of dollars). Previously we showed the adjusted statement effects with the present value method of amortization. We now include a column that depicts the results if CVS had used the straight-line method.

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **Adjusted** | **Adjusted** |
|  | **Reported** | **PV Depr.** | **S-L Depr.** |
| Net income | 3,461 | 2,932 | 3,022 |
|  |  |  |  |
| Current Assets | 18,594 | 18,954 | 18,954 |
| Long-term Assets | 45,949 | 54,746 | 54,746 |
| Total Assets | 64,543 | 73,700 | 73,700 |
|  |  |  |  |
| Current Debts | 11,956 | 14,002 | 14,002 |
| Long-term debts | 14,536 | 27,755 | 27,203 |
| Stockholders’ Equity | 38,051 | 31,943 | 32,495 |

What is at stake is whether the FASB (and the IASB) will fend off political and managerial pressures and promulgate rules that will give us useful lease accounting numbers. Note the large increase in long-term assets and the even higher increases in long-term debts. In addition, both of the adjustment methods generate less net income than the originally reported amount. And yes, these revised numbers better approximate economic reality than the GAAP numbers reported, which are just wrong. As we have suggested so many times, GAAP compliance does not guarantee transparency and financial statement quality. Current lease accounting is an excellent example.

The [Equipment Leasing and Financing Foundation](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/491) and the [Chamber of Commerce](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/538) have commissioned “research” reports that also claim the “sky will fall” if we capitalize leases. This is nuts. As we demonstrated in our criticisms of these reports, users believe that lease obligations are real liabilities, and they need to be recognized by the business entity.

One could argue that the capitalization of operating leases is unnecessary because outsiders like us can use FASB disclosures to adjust the statements if they wish. The fallacy of this argument is that we have to employ a number of assumptions when preparing this adjustment, thereby creating estimation errors. Corporate preparation and dissemination of the proper numbers reduces such errors.

We hear a lot about principles-based accounting, but principles-based accounting still requires principles-based regulators (and intestinal fortitude). If the FASB and the IASB cannot use their own definitions of liability to comprehend the fact that lease obligations are indeed liabilities, then financial reporting is in trouble. The FASB needs to act, and it needs to act now. And the IASB should do the same. Would this be reverse condorsement?

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*