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Lease Accounting: Major Changes on the Way?

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The deliberations haven't been a secret, but they have been quiet. And they'll definitely affect liabilities, bank covenants, and the overall financial position of many companies in a host of sectors, in particular, food processing and agricultural businesses.

We're talking about the 2009 proposal by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) that would establish a common standard for lease accounting. Nothing's final yet, but both parties have been busy working out the details, and an exposure draft is expected shortly. Once public comments are received and analyzed, a final standard should be issued in 2011.

So what, exactly, are the FASB and IASB proposing for this common standard? In short, they've developed an accounting model that will require lessees to recognize an asset (the lessee's right to use the leased item for the lease term) and liability (the obligation to pay the rental amount) in all lease contracts. It's a sweeping change that would eliminate off-

balance-sheet reporting of operating leases and increase the transparency and comparability of lease accounting.

And it could have a negative impact on many food processing and agriculture businesses.

While it's bound to have greater effects on some industries (such as retail and leasing companies) than others, most food processing and agriculture businesses have lease arrangements. Let's take a closer look at what this proposal could mean.

Decisions, Decisions

Changing the fundamental basis of lease accounting will alter core operating decisions for certain food processing and agriculture companies—for example, whether to lease or to buy and how to structure transactions.

A new common lease accounting standard may also drive changes in capital planning and budgeting processes. And the financial statement effects will certainly create a need to reconsider performance measures, key ratios (such as debt to equity), and financial covenants.

In a broader sense, changes in lease accounting will transform how companies are viewed from a financial perspective.

Bulkier Financial Statements

The proposal will add more assets and liabilities to financial statements, because so much was previously off the balance sheet. As a result, companies will have to reanalyze all their leases and apply the proper accounting



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treatment, even though this can be a costly and time-consuming process.

Which Leases Are in Scope?

Discussions are ongoing, but currently most leases are in scope, except those of intangible assets, leases to explore or use natural resources, and leases of biological assets. Also excluded would be contracts that represent the sale or purchase of an asset. The FASB and IASB will develop criteria so that it's clear when such an arrangement isn't considered a lease.

Drilling Deeper

There are several more-technical aspects of the lease accounting proposal worth noting.

In January the FASB and IASB tentatively decided to make concessions for short-term leases (such as for copiers and laptops) defined as having a maximum possible lease term of less than 12 months. They decided to permit lessees

to use a simplified form of lease accounting for such leases, in which the lessee would recognize the gross amounts payable and a corresponding right-of-use asset under a short-term lease in the statement of financial position. The concession for short-term leases would be optional for lessors.

In terms of measurement, the lessee's asset and the liability initially would be recorded "at cost," where cost is the present value of the lease payments, discounted at the lessee's incremental borrowing rate or implicit rate, if easily determinable. Cost would include estimates for contingent rentals. Subsequent measurement of the lessee's asset would be at amortized cost, and the income statement effect would be described as amortization rather than as rental expense. Impairment consideration under existing guidance would also be applied.

The lessor, using a performance obligation approach, would recognize an asset according to its right to receive rental payments from the lessee (a lease receivable) and a liability based on its performance obligations under the lease (its obligation to permit the lessee to use the leased item).

Revenue would be recognized over the lease term, as the performance obligation is met. Subsequent measurement of the performance obligation would be at amortized cost using the effective interest method.

Complex leases can have multiple components, such as renewal options, early terminations, purchase options, contingent rentals, and residual value guarantees. All the

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components of a lease would be viewed as a whole, rather than being valued as individual components.

Finally, as far as timing and transition are concerned, assets and liabilities arise and would be recorded when a contract is signed. In addition, a company would provide disclosures about the assets and liabilities that arose upon contract signing. At the effective date of the new guidance, a lessee would apply the new lease standard by recognizing an obligation to pay

rentals and an asset for the right of use for all outstanding leases at the transition date. No grandfathering of existing leases is expected to be allowed.

A Preliminary Strategy for Action

This new proposal is obviously significant—and potentially troubling for many businesses. But taking the steps to prepare now, as difficult

as the exercise may be, can go a long way toward minimizing disruption and excess cost later on.

First, consider how the anticipated changes will impact your financial statements at the time of adoption. In doing so, ascertain the potential impact on your debt covenants or lending arrangements. Then consider the implications of the impending standard as you make decisions regarding your capital expenditures and related financing activities in the coming months.

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