

NEW LEASE ACCOUNTING RULES

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working since 2002 on converging U.S. generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS). As part of those efforts, the FASB and IASB are currently working on a project to create a new standard for lease accounting that is expected to be released during the first half of 2011, with implementation of the standard expected for the year 2013.

As of the date of initial application all leases will be subject to the proposed accounting method.

The new standard is expected to require all leases to be accounted for on the balance sheet or statement of financial position as capital leases. This standard would eliminate the separate treatment for operating leases, which have historically been carried off the balance sheet and recorded as rental expense. However, this standard would only apply to assets considered property, plant, and equipment and would include a number of scope exceptions, including leases of intangible assets and contracts that represent the purchase or sale of the underlying asset.

ACCOUNTING BY LESSEES

Under the new standard, lessees would be required to recognize an asset representing their right to use the leased item for the term of the lease. The proposed guidance refers to that asset as a right-of-use asset. The lessee would also be required to recognize a liability for its obligation to make payments under the lease. The asset and liability would be measured using the present value of the lease payments.

The recognized lease term would be the longest possible lease term that is more likely than not to occur. In making that determination, the lessee would consider a number of factors, including any options to extend or terminate the lease. Lease terms would be reassessed at each reporting date. However, a detailed review of each lease would not be required unless a change in facts or circumstances indicates revision of the lease term may be necessary. Any change to the obligation to pay rentals due to reassessment of the lease term would be recognized as an adjustment to the carrying amount of the right-of-use asset.

ACCOUNTING BY LESSORS

For lessors, the proposed guidance requires lessors to determine whether the lease exposes the lessor to significant risks and benefits associated with the underlying asset, and if so, the performance obligation approach would be used. For all other leases, the de-recognition approach would be used.

Under the performance obligation approach, a lessor would recognize a lease receivable representing the entity's right to receive rental payments from the lessee and a liability for the entity's obligation to permit the lessee to use the leased item. The lessor would reduce the obligation and recognize the related revenue over the term of the lease.

Under the de-recognition approach, a lessor would record a lease receivable for the right to receive rental payments from the lessee, remove the asset being leased from the balance sheet (de-recognition) and record a residual asset representing the lessor's right to the underlying asset at the end of the lease term.





TRANSITION

The transition to the new proposals would require analysis of every existing lease as of the date of implementation of the new standard. This analysis is likely to be a significant burden for lessors and lessees with a large number of lease agreements.

The new lease accounting rules will have a significant impact to companies that are close to their maximum borrowing limits, or that have debt covenants that include a current ratio calculation of current assets to current liabilities.

HOW COULD THIS CHANGE [POTENTIALLY] IMPACT YOUR BUSINESS?

- Lower asset turnover ratios and capital, and an increase in debt-to-equity ratios could be the result of an increase in assets and liabilities
- Shorter term leases or buying an asset versus leasing may become more prevalent.
- A review of your accounting system is a must - lease contract management systems will require higher integration with lease accounting systems.
- If your taxes are based on GAAP amounts then state and local taxes will be affected.

The professionals at James Moore & Co., P.L. are prepared to discuss with you how your business will be affected by this change. Please feel free to contact us so we can work together to ensure your business moves forward in the best financial position possible.



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