The Changing Landscape of Lease Accounting for Nonprofits

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Summary:
Most nonprofits enter into arrangements to lease assets, and they enter into these arrangements as lessees. This article focuses on planned changes to the accounting standards from the perspective of lessee entities.

Many nonprofit entities enter into arrangements to lease assets. As such, those who are charged with governing and managing nonprofit entities must be aware of some significant changes that are planned in how lease arrangements are reflected in financial statements. Additionally, practitioners who are engaged to audit financial statements of nonprofits will want to be aware of the forthcoming changes.

Overview of the Proposed Guidance

In August 2010, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) released their joint proposal to change the landscape related to lease accounting. Under that proposed guidance, the current bright-line-based model of accounting for leases will be replaced with a right-of-use model. The end result is that, under most lease arrangements, lessee entities will need to record assets and liabilities.

While the date by which the new guidance will become effective is still undecided, final guidelines will be issued in June 2011. One key reason the planned guidance needs to be understood sooner rather than later is that all outstanding leases as of the effective date of the guidance will be subject to the new accounting model. There will be no grandfathering of existing lease arrangements, and prior-period financial statements presented for comparative purposes will have to be restated as if the new guidance had been in place in prior years.

Significant Changes From Existing Guidance

Current accounting and reporting standards related to leasing include capital leases and operating leases. Using the current bright-line model to distinguish between operating and capital leases, relatively small differences in lease terms can mean certain leases will be recorded as assets and liabilities, while other leases go unrecorded in financial statements. The result is that economically similar arrangements may be accounted for differently, diminishing the comparability of financial statements between and among reporting entities.

The planned new guidance will establish one single method of accounting for leases that requires recognizing assets and liabilities in financial statements associated with most lease arrangements, resulting in more complete and comparable financial reporting. This will also significantly reduce structuring opportunities related to achieving particular accounting results.

Nonprofits, in most circumstances, will need to recognize an asset representing the right-to-use the underlying (leased) asset for the lease term along with a liability to make lease payments. Arrangements currently in place that result in off-financial statement treatment must be considered in light of the new guidance so that assets and liabilities will be reflected in statements of financial position.

For arrangements currently considered to be operating leases (i.e., not recorded in the financial statements), rent expense amounts will be replaced with amortization expenses associated with the capitalized asset and interest expenses on the recorded obligation. Similar to the current guidance associated with capital leases, the right-of-use asset under all arrangements typically will be amortized using a straight-line approach. As in mortgage arrangements, interest expense associated with leases will be front-end loaded.

In order to prepare for implementing lease accounting changes, nonprofits should consider how to change their information systems in order to capture the information needed to implement the literature. Further, loan covenants in any debt agreements must be examined to determine if they need to be renegotiated because additional assets and liabilities will be reflected in the financial statements.

Short-Term Lease Considerations

Lessee entities could use a simplified accounting approach for short-term lease arrangements. Leases are considered to be short-term when their maximum possible term, including options to renew or extend, is 12 months or less.

In a FASB/IASB joint meeting in March 2011, the boards responded to the concerns of many constituents about the need to record assets and liabilities associated with short-term leases. The tentative conclusion reached was that lessee entities would be permitted to account for short-term leases in a manner consistent with current operating-lease requirements. For these types of leases, nonprofits can elect an accounting policy of not recording assets and liabilities in statements of financial position.

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