

Preview of the New Exposure Draft of the Lease Accounting Project

Key elements and commentary

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The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have announced they will issue a new Exposure Draft (ED) in March or April of 2012. It will likely have a 120 day comment period. This is good news for the industry as there are a few serious issues that we should comment on and hopefully get them to change their tentative decisions. At this point they have completed their deliberations other than a few minor issues and, so we know the likely content of the new ED in fairly good detail. Similar to the outcome on the first ED, getting the FASB/IASB to change their tentative decisions will depend on receipt of a large volume of comment letters with well developed arguments.

This article provides an overview of key elements of the new ED as best I know it based on the results of the Boards decisions to date. This article also provides commentary and discusses the remaining advocacy issues in italics and in the conclusion section.

Exposure Draft Preview of Key Elements and Commentary:

Scope: All leases of a “specified asset,” which includes leases of explicitly or implicitly identifiable property, plant and equipment as under current GAAP but also inventory items such as spare parts. Leases of intangibles remain outside the scope but may be account for leases by analogy as under current GAAP.

Definitions:

Definition of a lease: A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration. Guidance will not be provided in the leases standard for distinguishing a lease of an underlying asset from a purchase or a sale of an underlying asset. Such guidance will likely arise in connection with the newly proposed Revenue Recognition standard. If an arrangement does not contain a lease, it should be accounted for in accordance with other applicable standards (for example, property, plant, and equipment and loan accounting).

The definitions of specified asset and control are slightly less broad than current GAAP so fewer contracts will be considered leases, notably the dividing line between leases and service contracts

Lease Term: The lease term is defined as the contractual term plus renewals where the lessee has a “significant economic incentive” to exercise the options. Significant economic incentive as I understand it would include bargain renewals and renewals where the lessees would suffer an economic penalty for failure to renew.

There is some question as to the final wording but I understand the intention is to be essentially the current GAAP definition. This is an issue we have to see in print in the ED before deciding if the words and the stated intent match up.

Estimated Lease Payments: Includes interim rents, contractual rents, renewal and purchase options where the lessee has a significant economic incentive to exercise, termination penalties, the expected payment under residual guarantees, variable lease payments that are based on a rate or index and estimated variable payments based on usage or lessee performance that are “disguised” minimum payments (where the lease has below market contractual payments and has variable payments designed to “make up the difference” for the lessor). Those variable rents based on a rate (i.e. Libor) or an index (i.e. CPI) are booked based on spot rates with adjustments booked when the rate change changes contractual lease payments. However, in deliberations, the Boards tentatively decided to eliminate the requirement to estimate and record other contingent payments, notably those based on sales or excess asset usage. Estimates of renewal and purchase options are to be reviewed on each reporting date and if it becomes evident that the lessee has a significant economic incentive to exercise then the options must be recorded as estimated payments by adjusting the asset and liability balances. In addition the ROU asset amortization and imputed interest schedules are adjusted as though the transaction is a new lease beginning on the adjustment date.

As a consequence of the front loaded P&L cost pattern (see below) lease costs are accelerated when variable rent estimates change upward or when options are booked upon the reassessment adjustments. This creates earnings volatility and complexity. It may drive lessees to ask for shorter term leases – especially in the real estate industry.

Residual Guarantees: Estimated payments (not the full amount of the guarantee) under residual guarantees are booked as an estimated payment with review and adjustment at each reporting date. For lessors, a residual guarantee from the lessee or a third party does not change a residual to a financial asset (receivable). However, a manufacturer’s sale with a guaranteed resale or residual value would no longer be accounted for as leases. However, sales with buy-back agreements where the buy-back amount is less than the original sales price would be treated as leases.

The failure to classify a residual guarantee as a financial asset will limit the upfront gross profit recognition in sales type leases and limit the ability to finance it off balance sheet via the transfer of financial assets rules. However, lessees will generally capitalize

less than under current GAAP for leases containing residual guarantees set at expected value.

Short Term Lease and Short Term Renewals: A short term lease is a lease that at the date of commencement of the lease has a maximum possible lease term, including any options to renew or extend, of 12 months or less. Lessees can either account for payments under these as an operating expense or as capitalized amounts under the new model (see below). Lessors may elect, as an accounting policy for a class of assets, to account for all short-term leases like today's operating leases. Renewals with terms of 12 months or less are considered short term leases (eligible for off balance sheet operating lease accounting) where both the lessee and lessor have the right to terminate the renewal without significant penalty.

This means that typical fleet/spilt TRAC/synthetic leases that have 12 month terms and month to month termination/renewal options will not be considered short term leases.

This also means that renewals of most leases will be operating leases (not capitalized, that is, off balance sheet).

Lessee Accounting

Initial accounting is done at commencement (not at inception as proposed in the first ED) and is to capitalize all leases (except short term leases) as a right of use (ROU) asset and lease liability at the present value of the estimated lease payments. The present value discount rate is the lessee's incremental borrowing rate or the implicit rate in the lease, if known. For subsequent accounting, the ROU asset is amortized straight line over the lease term and interest is imputed on the lease liability. Adjustments to estimated payments change the ROU asset and lease liability values and change the remaining ROU asset amortization and imputed interest on the liability. Lessees must separate non lease costs from bundled lease payments using observable market information. If the lessee cannot determine the breakdown the full payment must be capitalized. Lessees may elect to use the operating lease method for short term leases. Sale leasebacks that qualify as sales under the revenue recognition rules (there is a conflict re the definition of a sale and a financing versus the leases project – specifically if the leaseback has a purchase option revenue recognition rules say it is not a sale) are accounted for by removing the asset, recording the leaseback as an ROU asset and a lease liability with any gain/loss recorded upfront. Sale leasebacks that do not qualify as sales are accounted for as a financing (loan). Subleases are accounted for as a lease in (capitalized as an ROU asset and lease liability) and a lease out as either an R&R lease or an operating lease (the determining factors are not clearly defined).

The most important advocacy issue is the front loaded lease cost pattern for the former operating leases. I contend that straight line rent expense best represents the economic benefit from use of the leased asset for the lessee, unless as under current

GAAP another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset. Additionally, I contend the proposed cost patterns create a mismatch in balance sheet values of the ROU asset and lease liability that does not reflect the "fair value" of the lease contract, the initial unit of account where these items are linked. I contend the leased asset and related liability should remain linked thereafter assuming equal periodic utilization of the economic benefits and no impairment. The sale leaseback question is also an important advocacy issue. As is stands it means all sale leasebacks with purchase options would be treated as loans and the asset remains on the seller/lessee's books.

Lessor Accounting

Four methods/lease types are identified for lessors:

- The "receivable & residual" (R&R) method is to be used for all leases of the entire asset to one lessee. This method produces results much like direct finance lease accounting for third party equipment, However, since this model does not distinguish between leases based on the significance of the assumed residual, the concept of a sales-type lease has been eliminated. The recognition of gross profit is limited to the profit on the right-of-use asset transferred, calculated by multiplying the total gross profit by the percentage derived by comparing the present value of the lease receivable to the fair value of the underlying asset.
- Short term leases may upon election be accounted for using the current GAAP operating lease method,
- Investment properties (land and buildings) for qualifying real estate lessors that are investment companies use the "investment properties" method, that is, operating lease accounting with fair valuing of the leased asset, and
- A "multi-lessee" exception allowing lessors in leases of investment property (commercial real estate) to use existing operating lease accounting.

Under the R&R method assets are the PV of the estimated lease payments receivable using the rate the lessor charges the lessee (generally, the implicit rate in the lease for equipment leases) and the residual (derived by subtracting the PV of the receivables from the book value of the asset). Where there is no sales-type gross profit, the residual is accreted to its expected fair value using the implicit rate in the lease. Where there is a gross profit in the lease, the portion of the gross profit attributed to the residual is deferred and the residual is accreted to its expected fair value less the deferred profit. The accretion rate is a derived IRR rate (not the implicit rate in the lease). If the lease payment is bundled, including non lease costs, the lessor must account for the non lease costs separately as under current GAAP.

Failure to recognize the residual at its fair value in sales-type leases means less upfront

profit will be recognized compared to current GAAAP. The failure to recognize that a residual guarantee changes the nature of the residual to a financial asset further reduces upfront sales-type gross profit recognition.

Leveraged lease accounting is eliminated with no grandfathering. This is a FASB only issue.

Failure to allow netting of the receivable and debt service overstates the assets and liabilities on the balance sheet. The failure to allow use of the after-tax yield to recognize revenue distorts the economic effects of leveraged leases as well as non leveraged tax leases.

Transition

For lessees, existing capital leases are grandfathered. All operating leases must be capitalized with a lease liability recorded equal to the present value of the remaining rents using the current incremental borrowing rate. The offsetting ROU asset is adjusted by a ratio of remaining rents to total rents and the amount of the difference between the ROU asset and lease liability is charged to retained earnings. For sale leasebacks if the leaseback is a capital lease it is grandfathered and any gain continues to be amortized to P&L. If the sale leaseback is an operating lease the original sale leaseback assumptions must be re-evaluated under current rules possibly being re-booked as a financing or booked as an ROU lease under the lessee transition rules with any unamortized gain booked to equity. In any case a lessee may chose full retrospective accounting for all its leases.

The adjustment to the ROU asset charged to retained earnings is an attempt to lessen the front ended lease cost pattern resulting from the proposed rule. It is overly complex. If the lease cost pattern was straight line there would be no need for the complexity. Charging retained earnings versus current P&L does not change the issue that the front loaded cost allocation methodology does not reflect the economics of a lease to the lessee.

For lessors, existing direct finance and sales-type lease are grandfathered. All operating leases are recorded as though they are new leases for their remaining term using the new lessor methods prescribed. For R&R leases the existing lease book value is derecognized and the present value of the rents is recorded. The residual is a plug where there is no gross profit in the leases. Where there is an existing gross profit in the operating lease to be capitalized details are not specified. Leveraged leases are booked as R&R leases with the rents and debt reported gross on the balance sheet. *Existing leveraged leases should have been grandfathered as well.*

Conclusion - We as an industry got many of the changes we pointed out in comment letters to the original ED, notably those aligned with the comments of the users of financial statements. The changes make the proposed rule that we expect in the new ED more reasonable but there remain several advocacy issues:

- Most important is that the Boards recognize that there are 2 types of leases for lessees and allow straight line expense recognition for the leases that are now considered operating leases.
- The definition of the lease term must be clarified
- Sale leaseback accounting criteria must be clarified as the revenue recognition project has a differing definition of a sale and a financing than the leases project
- Lessees and lessors need relief from the complexity and compliance burden in areas like transition, adjustment of estimates in the lease term, accounting for variable rents and disclosures.
- We need to get some relief in accounting for leveraged leases – at least to grandfather existing deals and to net the rent and the debt on new leases to better reflect the economic risks for the lessor. The after tax yield argument is valid as well for leases with tax benefits but the Boards are reluctant to open up revenue recognition and accounting for income tax rules to deal with taxes.
- Regarding sales-type lease profit recognition, we need to at least get the Boards to allow greater gross profit recognition if the residual is guaranteed or insured.
- Equipment lessors who actively manage their leased assets would prefer to be allowed to continue to use operating lease accounting using the same logic used to grant real estate lessors an exception to using the R&R method.

To get these points addressed we need a large volume of comment letters that present the issues, explains why they need to be addressed, and suggest outcomes with sound accounting and business arguments.

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