



## **MONITORDAILY SPECIAL REPORT**

### **Lease Accounting Project Update as of May 25, 2011**

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The high volume of comment letters (780+) and numerous outreach meetings had common criticisms causing the FASB/IASB Boards to re-deliberate issues in the Leases Project Exposure Draft ("ED"). At first the Boards made tentative decisions in line with the comment letter criticisms that were favorable to the industry. But at a meeting on May 19, they reversed some of them. It appears that the project outcome is unsettled now. The Boards had seemed to be listening to feedback, but now seem to be thinking that many of their decisions made in the ED will stand. This is surprising to me as the feedback from users of financials (equity and debt analysts, lenders and investors) on the information they find useful in financial statements regarding leases is being ignored. The decisions to date, with the caveat that they will likely change, along with my commentary are as follows:

#### **Re-exposure**

I thought it was likely for a re-exposure to occur with a short comment period (60-90 days vs. the standard 120 days), but in light of the change in direction back to the decisions in the ED a re-exposure is less likely.

#### **Issuance date**

Still trying for 2011, but they have said it will slip to late in the year re-exposure will likely delay the project completion to the end of 2011 or beginning of 2012.

#### **Effective date**

Tentatively decided on 2015. and I think that will hold.

#### **Lessee Transition Method**

To lessen the negative P&L impact of using a prospective method in transition, they are considering the full retrospective method. This will smooth the current P&L but will result in a large hit to retained earnings. It will also be burdensome to go back to the inception of each lease.

#### **Scope**

Includes leases of assets that are property, plant and equipment. Although it excludes intangibles, the scope will be worded so that leases of intangibles like software can be accounted for as leases by analogy. One big 4 firm thinks this may allow software developers to get sales type lease profits.

### **Definition of a lease (need to distinguish from service contract)**

Regarding leases versus installment purchases, the Boards decided to eliminate the scope exclusion, but lease contracts should be accounted for in accordance with the leases standard and lease contracts that represent a purchase or sale of an underlying asset should be accounted for in accordance with other applicable standards (e.g., plant and equipment and loan accounting by lessees). They are seeking feedback on the definition of a lease versus an installment sale where the option is a bargain and how re-assessment of the likelihood of exercise of a purchase option should be handled. The Boards recommended that further outreach activities should include the issue of installment sales in the definition of a lease.

The Boards agreed to tentatively confirm the 'specific asset' notion versus a notion of an asset of a certain specificity. Physically distinct portions of a larger asset can be specified assets and non-physically distinct portions are not specified assets. The description of "control," as defined in the Leases ED, should be revised to be consistent with the revenue recognition project while including guidance on separable assets. The Boards agreed that the right to control the use of a specified asset is conveyed if the customer has the ability to ***both*** direct the use of the asset and receive the benefit from its use. The Boards decided to require an assessment of whether, in contracts where the supplier directs the use of the asset used to perform customer services, the asset explicitly or implicitly identified in the contract is an inseparable part of the services. If the asset is inseparable, the customer would be deemed not to have the right to control the use of the asset and the arrangement would be accounted for as a service contract with no embedded lease of that asset. Under the newly-proposed guidance, any one of the following may indicate the customer has obtained the right to control the use of a specified asset: 1.) The customer controls physical access to the specified asset; 2.) The design of the asset is customer-specific and the customer has been involved in designing the specified asset; 3.) The customer has the right to obtain substantially all of the economic benefits from use of the specified asset throughout the lease term.

They did not conclude on, but are in favor of, concepts like not including in lease accounting assets that are incidental to the provision of a service or insignificant to the services provided. The decisions will mean fewer contracts are considered leases versus current GAAP, including EITF 01-08. (The revised guidance would result in certain contracts that are considered leases under current standards, e.g., certain take-or-pay contracts, to no longer be considered leases.)

### **Rates for lessee and lessor accounting**

Lessees use their incremental borrowing rate, unless the implicit rate in the lease

is known, to capitalize the lease and impute interest expense in the P&L. Lessors use the implicit rate in the lease to calculate the receivable and residual assets and to accrue revenue.

They made an important change in previous tentative decisions. They decided that the lessee must use the new, current incremental borrowing rate to adjust for changes in estimates of the lease term. This reintroduces a high level of complexity and volatility in reported results. They did say they would revisit the issue of the lessee discount rate in future meetings. Other changes to estimated payments would not require a change in the discount rate.

### **Lessor accounting model**

The Boards are split, and they need to meet again to settle major lessor accounting issues. The IASB favors a derecognition model for all leases (good news for the industry). The FASB favors two models based on a risks and rewards analysis using IAS 17-like classification criteria. The FASB's two models are the derecognition model and the existing operating lease model. The Boards will have to resolve the split on this issue.

They seem to agree on the following factors in the derecognition model:

- There will be partial derecognition where sales type profit will be limited to the ratio of the PV of the rents to the fair value of the asset. The balance of the profit related to the residual would be deferred.
- Allocate the asset between receivable and residual by present valuing the cash flows using the implicit rate.
- Accrete the residual over the lease term using the implicit rate in the lease.
- Present the receivable and residual assets separately on the balance sheet.

The preferred outcome in lessor accounting is that equipment leases should get derecognition treatment which is very similar to the current direct finance lease method. The tentative decision to accrete the residual is important good news.

Leveraged lease accounting will not be included in the new rule. There is a chance they may allow grandfathering of existing deals. There is also a chance that netting will be allowed for new leveraged leases under a "Balance Sheet-Offsetting" project that they are separately working on. It is unlikely they will allow tax affected yield revenue recognition because they say they would have to take up a revision to income tax accounting which they do not have time for now.

### **Lessee P&L pattern**

It appeared that the Boards would allow former operating leases (now called “other than finance” leases) classified using IAS 17-like criteria to have straight line P&L cost pattern labeled as rent expense, but they reversed that tentative decision unexpectedly. The lessee cost pattern will be front ended. It will be comprised of amortizing the right of use asset (PV of the rents) and imputed interest at the incremental borrowing rate on the capitalized lease obligation (PV of the rents). This is an extremely unpopular decision. It will have unintended consequences regarding contracts and regulations that allow cost reimbursement for rent. The reason they reversed their view is they could not justify using other than straight line to amortize the right-of-use asset.

### **Lease term**

The lease term is tentatively defined as the contractual term plus renewals where the lessee has a “clear economic incentive” to exercise the options. This is essentially the current GAAP definition. Hopefully they will decide that a renewal or extension is a new lease to avoid complex adjustments, but that remains to be seen.

### **Purchase options**

Subject to feedback from outreach they decided the exercise price of a purchase option should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments only when there is a *significant* economic incentive to exercise the purchase option. If so, the ROU asset should be amortized over the useful life of the asset. Other purchase options are not considered lease payments to be capitalized. These conclusions are consistent with their conclusions on the lease term and renewals so it is good news except for the concerns re: reassessment. Further outreach is needed regarding when to reassess the purchase option and how reassessment affects lease classification now that the concept of “finance” leases and “other than finance leases” have been reintroduced into the project for both lessors and lessees.

### **Variable payments**

Variable lease payments will be included in the lease payments to be capitalized by the lessee and to be included in the lessor's lease receivable, but the specific variable payments will be limited vs. what was proposed in the ED. Details are as follows:

- All variable lease payments that depend on an index (e.g. CPI) or a rate (e.g. LIBOR based floating rate leases) must be estimated and booked using the spot rate. They have not fully worked out how changes in the index or rate will be accounted for. This still means some complexity for floating rate equipment leases, like fleet leases, although they allow use of the spot rate rather than forward rate to calculate the future payments. It also means it is likely the complexity of capitalizing and adjusting real

estate leases with CPI variable rent clauses will still be extremely burdensome;

- Other variable lease payments based on usage (e.g. cost per mile) or lessee performance (e.g. rents based on sales) will not be capitalized unless they are deemed to be “disguised” minimum payments. This is good news for both the equipment and real estate leasing industries as it will lessen the complexity and amounts capitalized. Guidance on determining when variable rents are disguised lease payments are to be decided. The object is to capture transactions structured to lessen capitalization by having below market contractual rents but with variable rents that are virtually certain to occur and will “make up for” under market contractual rents;
- Disclosure will be required within the notes of contingent rent leasing arrangements (details to be determined later).

### **Residual Guarantees**

They reiterated their conclusions that: A third party residual guarantee is not a minimum lease payment for the lessor ( this is not good news); lessees should only record the likely payment under a residual guarantee, not the full amount of the residual guarantee but rather the amount it is in the money.

### **Short term leases**

It appeared that the Boards would allow short term leases to use the current operating lease method but they reversed that decision and are now reconsidering how to handle them. It appears likely there will not be an exception made for short term leases. A short term lease is defined as, 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. This means that typical fleet/spilt TRAC/synthetic leases that have 12 month terms and month to month renewal options will not be considered short term leases.

### **Sale leasebacks**

If the transaction is considered a sale under the revenue recognition standard (means that control of the asset has been transferred) account for the transaction as a sale leaseback, otherwise consider it a financing/loan. When the sales price and leaseback rents are at fair value, gains or losses arising from the transaction are recognized immediately. When sales price and rents are not at fair value, the assets, liabilities, gains and losses should be adjusted to reflect the current market. This is good news as the criteria for determining a sale are less onerous than current GAAP (FAS 98) and the profit recognition is up front for most deals versus current GAAP that causes deferral and, in most cases, amortization of gains in sale leasebacks.

### **Lease inception vs. commencement**

Lessees and lessors initially measure (calculate the amount capitalized) and recognize (book) the lease assets and liabilities at the date of lease commencement. Lessees use incremental borrowing rate at lease commencement to calculate the amount capitalized. This is good news as it simplifies the lessee accounting.

### **Pre-commencement payment/interim rents**

Interim rents are recognized as a rent prepayment and at the date the commencement the prepayments will be included in the cash flow discounting to determine the value of the right-of-use asset and capitalized lease obligation. Interim rents are now officially part of the capitalized lease amount and as a result, lessees will be more aware of the cost of the lease.

### **Lease incentives**

Cash payments received from the lessor are included as a cash inflow in the cash flow discounting to determine the value of the right-of-use asset and capitalized lease obligation.

### **Bundled lease payments**

Payments must be bifurcated by lessees and lessors. Bifurcate using observable stand alone prices if know for all elements, consistent with the revenue recognition project; if only one element is observable assume the cost of the other is the residual cost. Where no observable market prices available, lessees capitalize the whole payment as a lease. Unless they are more lenient in allowing estimates when market rates are not available to the lessee (they are considering it), this will mean that lessors will be forced to disclose the breakdown of elements in a full-service lease as lessees will not accept capitalizing the full bundled payments.

### **Initial direct costs**

These are costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

Lessees and lessors should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively.

### **Conclusion**

It appeared that the industry (both lessees and lessors) would fare very well in the re-deliberations, but that is now not so. It appeared the rules would be simpler and closer to current GAAP on the lessee side, but they re-introduced accelerated P&L costs, will likely not to call the expense rent and added back complexity in deciding to change the incremental borrowing rate if the lease term assumptions change. There still are major concerns with lessor issues although progress seems to be more in line with the industry views. It looked like the

comment letter process would influence the FASB and IASB. Unfortunately that does not seem to be the case with the Leases project. I urge you all to stay current on the project as it progresses. You should all comment when and if the re-exposed ED comes out later this year. You may wish to provide unsolicited comments now on the process and new decisions. Please do comment before it is too late!

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