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MONITORDAILY SPECIAL REPORT
Lease Accounting Project Update as of June 21, 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 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 most users of financials (equity and debt analysts, lenders and investors) on the information they find useful in financial statements re 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, but in light of the change in direction back to the decisions in the ED and their recently revised target date of Y/E 2011 a re-exposure is less likely. I think it is absolutely necessary to re-expose a new ED as they have changed the lessee accounting significantly, never described the current lessor methods being considered and ignored user and preparer comments regarding lessee P&L among other issues. Readers and your lessee customers should write to director@fasb.org to express your views on the need for re-exposure and any issues that you have with the decisions to date – see below.

Issuance date
New target date is year-end 2011. In my opinion it will slip into early 2012.

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

Lessee Transition Method
To lessen the negative lessee accounting P&L impact of using a prospective method in transition they are considering the full retrospective method as either an option or a requirement. This will smooth the current P&L but will result in a large hit to retained earnings and the creation of a large deferred tax balance. It will also be burdensome for lessees 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 vs. 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 vs. 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: (a) The customer controls physical access to the specified asset; (b) The design of the asset is customer-specific and the customer has been involved in designing the specified asset; (c) 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 vs. 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 re-look the issue of the lessee discount rate in future meetings. Other changes in estimated payments would not require a change in the discount rate.

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. It will eat up capital for banks. It will eat up capital and profits for retailers. It will create huge deferred tax assets as the lease costs will be largely non-cash charges in the early years of every lease. For a growing company ease costs will never level off. Inflation alone will mean most companies will never see lease costs leveling off unless they cut back on leasing. The reason they reversed their view is they could not justify using other than straight line to amortize the right-of-use asset as their Conceptual Framework does not contemplate capitalizing executory contracts. In my opinion they are working too fast to analyze capitalized executory contract issues and amend their Conceptual Framework.

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. There is some confusion as to what was said at their recent meetings but the staff assures me the final draft will be very much the same as current GAAP where the renewal options have to be a bargain or create economic compulsion to exercise to be considered a minimum lease payment to be capitalized. Hopefully they decide that a renewal or extension is a new lease to avoid complex adjustments, but that remains to be seen.

Termination Option Penalties

The accounting for termination option penalties should be consistent with the accounting for options to extend or terminate a lease. If a lessee determines it will terminate a lease early and would be required to pay a penalty, the term is shortened and the termination penalty is considered a lease payment to be capitalized. If a lessee would be required to pay a penalty if it does not renew the lease and the renewal period has not been included in the lease term, then that penalty is considered a lease payment to be capitalized.

Purchase options
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.

Reassessment of Options in a Lease

The Boards discussed how lessees and lessors should reassess whether a lessee has a significant economic incentive to exercise:

- An option to extend or terminate a lease, and
- An option to purchase the underlying asset.

The Boards tentatively decided that a lessee and a lessor should consider whether it has a significant economic incentive to exercise an option. The Boards tentatively decided that the thresholds for evaluating a lessee's economic incentive to exercise options to extend or terminate a lease and options to purchase the underlying asset should be the same for both initial and subsequent evaluation, except that a lessee and lessor should not consider changes in market rates after lease commencement when evaluating whether a lessee has a significant economic incentive to exercise an option.

The Boards tentatively decided that changes in lease payments that are due to a reassessment in the lease term should result in:

- A lessee adjusting its obligation to make lease payments and its right-of-use asset; and
- A lessor adjusting its right to receive lease payments and any residual asset, and recognizing any corresponding profit or loss (pending the Boards' decision on lessor accounting).

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).

In my opinion they have not gone far enough to simply the variable payment accounting for CPI based variable rents as every time the CPI variable rent changes it will require a complex adjustment. It is a form of inflation accounting that we do not apply to other areas in accounting.

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;
- residual guarantees should be reassessed when events or circumstances indicate that there has been a significant change in the amounts expected to be payable under residual value guarantees. An entity would be required to consider all relevant factors to determine whether events or circumstances indicate that there has been a significant change;
- changes in estimates of residual value guarantees should be recognized (a) in net income to the extent that those changes relate to current or prior periods and (b) as an adjustment to the right-of-use asset to the extent those changes relate to future periods. The offsetting entry is an increase or decrease in the capitalized lease obligation. The allocation for changes in estimates of residual value guarantees should reflect the pattern in

which the economic benefits of the right-of-use asset will be consumed or were consumed. If that pattern cannot be reliably determined, an entity should allocate changes in estimates of residual value guarantees to future periods. In my opinion the charges should be allocated to future periods, meaning the entry is an increase or decrease in the ROU asset and the new balance in the ROU asset is straight lined over the remaining lease term.

Short term leases
It the Boards would allow short term leases by asset class election to use the current operating lease method but they modified that decision and are now reconsidering expanded disclosures. The need for disclosures means that lessees will have o do almost all the work they would have done if they applied ROU accounting to the short term leases. I say this is a lot of work for an item that is immaterial to virtually every company. I think this is a case of the Boards making a decision without field testing to see if there are in fact companies with significant 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 termination/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. This is bad news for the banks that did sale leasebacks to raise capital. Not only will the asset come back on books but the P&L cost will be accelerated as the ROU asset is written off over the lease term not the economic useful life as well as the general front loading pattern of the proposed lessee accounting.

Contract Modifications or Changes in Circumstances after the Date of Inception of the Lease

The Boards tentatively decided:

- A modification to the contractual terms of a contract that is a substantive change to the existing contract should result in the modified contract being accounted for as a new contract. As a result, the existing lease would be closed out and a gain would result because of the front ended pattern of accounting for the lease costs. A new lease would then be recorded.
- A change in circumstances other than a modification to the contractual terms of the contract that would affect the assessment of whether a contract is, or contains, a lease should result in a reassessment as to whether the contract is, or contains, a lease.
- A change in circumstances other than a modification to the contractual terms of the contract that would affect whether a lease transfers substantially all of the risks and rewards incidental to ownership of the underlying asset should not result in a reassessment or a change in the accounting approach.

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. Although it is yet to be clarified as it reads, for leases with interim fundings, the earnings on the interim rents will be deferred and amortized over the lease term beginning at the commencement date 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, 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. These are third party costs.

Lessees should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and as a result the initial direct costs will be amortized straight line over the lease term. Lessors will include the initial direct costs as a reduction in the amount of the right to receive lease payments pa=laced at time zero. The effect is to reduce the implicit rate and as a result the lease revenue recognized over the lease term will be reduced.

Foreign Exchange Differences

The Boards discussed the accounting by lessees for leases denominated in a foreign currency. The Boards tentatively decided that foreign exchange differences related to the liability to make lease payments should be recognized in profit or loss, consistently with foreign exchange guidance in existing IFRSs and U.S. GAAP.

Impairment

The Boards discussed impairment of the lessee's right-of-use asset. The Boards tentatively decided to affirm the proposal in the Leases Exposure Draft to refer to existing guidance in IFRSs and U.S. GAAP for impairment of the right-of-use

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 with partial sales type gains recognized and a method similar to the existing operating lease model with a lease receivable booked (the contra entry to the receivable booked is to a deferred credit type account that will be amortized at the same rate that rents are received). 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 very low chance they may allow grand fathering 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

Investment Property Accounting for Real Estate Leases

The FASB is working on a proposal to allow investment property accounting for US real estate leasing companies. That is they use current operating lease accounting but must fair the residual asset. The proposal in discussion will allow this only if the leasing company is an investment company. This is as opposed to IAS 40 which already exists for IASD companies that allows the accounting method for all real estate leasing companies in addition to having the fair value residual accounting as an option. This is viewed as either restricting the use of investment property accounting in the US or viewed as a negative if the company qualifies as an investment company as it is then subject to all the aspects of investment company accounting.

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 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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