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Bosco: Lease Accounting Project Update as of August 1, 2011

Equipment leasing expert and industry consultant Bill Bosco provides his most recent update to monitordaily with in-depth commentary on the latest developments in the continuing debate on lease accounting standards.

What's new?

They decided:
* to re-expose (good news)
* to kill and nit grandfather leveraged leases (very bad news)
* to have one lessor model (mostly good)
* to define lessee disclosures (extensive)

Introduction

The project is nearing completion but the Boards have decided to re-expose the proposed rule - great news. At first the Boards made tentative decisions on lessee accounting in line with the comment letter criticisms that were in line with views of the industry, lessees and many users of financial statements. Unfortunately they reversed the decision on lessee P&L treatment so that now the project assumes the lease cost pattern will be front ended. The decisions on lessor accounting are a mixed bag. The good news is they adopted one lessor model much like the current direct finance lease method which will mean more leases will be sales type leases. The bad news is sales type gains will be limited. Also leveraged lease accounting is eliminated with no grandfathering. The decisions to date, with the caveat that they will likely change, along with my commentary are as follows:

Re-exposure and Issuance Date

Re-exposure will occur with a 120 day comment period. The new exposure draft will be issued in the next few months. With this development the project completion date will likely be in mid 2012. Readers and your lessee customers should follow this process closely, read the new draft and comment to director@fasb.org to express your views.

Effective date

Tentatively decided on 2015 and I think that will hold.

Lessee Transition Method

Early adoption will be allowed for IFRS preparers and first time IFRS adopters. 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. The full retrospective method will smooth the lessee P&L impact as it would move the initial "hit" of front ending lease costs to the inception of each lease. This will result in a large hit to retained earnings and the creation of a large deferred tax balance. This will be a problem for a capital strapped banking industry. It will also be burdensome for lessees to go back to the inception of each lease. The proposed modified retrospective approach would start the new accounting method for each lease beginning in the earliest period presented when a lessee converts. This means that each existing leases will have a front ended pattern as though it was a new lease but with a term equal to the remaining term. This method will create large increases in lease costs until the lessee's lease portfolio reaches a point where an equal amount of expiring leases are replaced by new leases.

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 of what are now classified as operating leases 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. If the accounting profession does not recognize that some leases are different (rentals versus financings of the underlying leased asset) it will break the long standing view held by the US tax and legal regimes consistent with FAS 13 and IAS 17. I do think the best course is to continue to account for lease costs in operating leases using the straight line rent as the expense as it will resolve the issues of rent cost reimbursement and distortions to P&L, capital and deferred taxes. This will only be achieved if there is a large volume of well thought out comment letters from lessees, users of financials (lenders, banks, debt analysts, equity analysts and investors) and regulators.

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:

1. An option to extend or terminate a lease, and

2. 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:

1. A lessee adjusting its obligation to make lease payments and its right-of-use asset; and

2. 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. Changes to the rate or index will mean the lease will have to be adjusted. This still means some complexity for floating rate equipment leases, like fleet leases. It also means it is likely the complexity of capitalizing and adjusting real estate leases with CPI variable rent clauses will still be 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.

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

The Boards allow the current operating lease method for short term leases by asset class. This election applies to lessees and lessors. Lessees are required to disclose the future expectations to use short term leases so that users of financials can determine future lease costs and uses of cash

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 placed 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

Lessee Disclosures

The lessee must:
* Describe the nature of, and restrictions imposed by, lease arrangements.

* Provide information about judgments and assumptions relating to amortization methods, renewal options, contingent rentals, termination penalties, residual value guarantees, and discount rate and changes to those judgments and assumptions.
* Sale and leaseback terms and conditions, gains and losses.
* A reconciliation between the opening and closing balances for right-of-use assets and liabilities to make estimated future lease payments. The ROU reconciliation must be disaggregated by class of leased property.
* A maturity analysis of the gross undiscounted liability to make estimated future lease payments on annual basis for the first five years, and a lump sum for the remainder, showing contractual maturities, reconciled to the liability recognized.
* Lessees applying U.S. GAAP would be required to include in their maturity analysis cash flows related to services embedded in lease contracts that are accounted for separately from the leases.
* A tabular disclosure of all expenses related to leases not included in the lease liability and right-of-use asset, and short-term lease expense.
* Separately disclose the cash paid relating to the lease liability.
* A qualitative disclosure about circumstances or expectations that the entity's short-term lease practices would result in a material change in the next reporting period.

In my opinion the lessee disclosures are inadequate for users who view operating leases as creating a straight line cost pattern and an operating cash outflow. It also does not deal with the lease cost reimbursement of operating lease payments issue. The Boards are ignoring this issue and I predict a large outcry in the comment letters to the new exposure draft.

Lessor accounting model

The Boards decided that there will be one lessor accounting method for all leases called the "receivable residual" ("R&R") method. There are 2 exceptions - short term leases can be accounted for under the current GAAP operating lease method and certain real estate leases can be accounted for at fair value using the investment properties method. The assets under the R&R method are the PV of the rents using the lease's implicit rate and the residual. The residual is the difference between the PV receivable and the leased asset fair value. Under the R&R method upfront sales-type profit is allowed for all leases as long as profits are "reasonably assured"(should not be a big issue for equipment leases as the considerations are uncertainty about the residual value, uncertainty re the split between executory costs in a lease with services and uncertainty about the fair value of the leased asset at inception) but 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 portion is deferred. The residual is accreted to its estimated value at lease expiry using the implicit rate in the lease. If profits are not "reasonably assured" the sales-type gross profit is spread over the term by accreting the residual at the IRR of the plugged residual (difference between the PV receivable and the cost of the leased asset) and the expected residual value at expiry.

Leveraged lease accounting will not be included in the new rule. They will not allow grand fathering of existing deals. They will not allow a tax affected revenue recognition method. There is also a low probability that netting will be allowed for new leveraged leases under a "Balance Sheet-Offsetting" project that they are separately working on, but this is not assured. This is another FASB/IASB project that leveraged lease lessor community should be following and commenting 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 entirely so. Most of the views expressed by the industry were adopted. Those views were also held by the vast majority of lessees and users of financial statements. The 2 major issues that have not been adopted are straight line lessee P&L cost and the retention of leveraged lease accounting. I urge you all to stay current on the project as it progresses. You should all comment when the re-exposed ED comes out later this year. You may wish to provide unsolicited comments now on the process and recent decisions to director@fasb.org. Please do comment before it is too late!

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