FASB/IASB 3/18-19 Meeting Notes

Executive Summary:

The Boards remain at odds on the key issue of how lessees should account for all leases once leases are recognized on balance sheet. The debate is over using one method (capital lease Type A accounting) to account for all leases or using two methods, which would retain current GAAP's distinction between capital and operating leases for expense purposes. Under this approach, the former operating leases would retain straight line rent expense. They are also at odds as to whether to extend exemptions for small leases and leases of non specialized assets, and they differ on the approach to lessor accounting, but are much closer on that topic (and are closer to a converged answer) than they are on lessee accounting. They will continue to work towards a conclusion of the project, but it appears they may have important differences. We may see two standards issued that are converged for day 1 lessee accounting – that is that all leases are capitalized – but not converged on subsequent accounting for lessees and the exemptions for certain small non-specialized asset leases. The next step will be to meet again but no date was set for that meeting.

Details:

The Boards discussed and voted on the following approaches to move forward at a future meeting to be announced:

Lessee Accounting Model: The following four approaches were presented:

(i) **Approach 1** – A single approach for ***<u>all</u>*** leases, accounting for all leases as the purchase of a ROU asset on a financed basis (Type A method is like current GAAP for capital leases, recognizing amortization of the ROU asset and imputed interest on the lease liability).

(ii) **Approach 1A** – A dual approach that would permit (but not require) lessees to account for most real estate leases as Type B leases (that is, recognizing a single lease expense -- the average rent -- rather than amortization and imputed interest separately).

(iii) **Approach 2** – A dual approach, with lease classification similar to that proposed in the 2013 ED with virtually all equipment leases being Type A leases, while most real estate (including integral equipment) leases would be Type B leases.

(iv) **Approach 3** – A dual approach, with lease classification determined in accordance with the risks and rewards principle in existing GAAP. Under this approach, a lessee would account for the vast majority of existing capital leases as Type A leases, and the vast majority of existing operating leases as Type B leases). The classification tests/criteria (taken from IAS 17) proposed are:

> *A lessee would effectively obtain control of the underlying asset when any one of the following three criteria is met at lease commencement:*
> *(a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.*
> *(b) The lessee has a significant economic incentive to exercise an option to purchase the underlying asset (note: if the Boards decide to revise the notion of significant economic incentive, the staff would propose to revise this criterion accordingly).*
> *(c) The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease. Situations that individually or in combination would normally indicate that the lessee has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease include:*
> *(i) The lease term is for a major part of the remaining economic life of the underlying asset.*
> *(ii) The sum of the present value of the lease payments and any residual value guaranteed by the lessee amounts to substantially all of the fair value of the leased asset.*
> *(iii) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.*

The Vote: The IASB favored Approach 1 while the FASB favored Approach 3.

Commentary: Although the Boards agree that operating leases should be capitalized (day 1 accounting) they are far apart on whether there is more than one type of lease and how the P&L cost for the former operating leases should be accounted for. It is possible the IASB and FASB will issue separate standards with only partial convergence on lessor accounting and capitalization of all leases by lessees. The ELFA favors the FASB view where former operating leases would continue to use the average rent as the lease cost.

Lessor Accounting Model: The following three approaches were discussed with respect to classifying leases as either Type A or Type B within the dual lessor accounting model:

(i) **Approach 1** – An approach that would determine lessor lease classification (Type A vs. Type B) based on whether the lease is effectively a financing/sale, rather than an operating lease based on a risks and rewards analysis using IAS 17 like classification tests as quoted above, including third party residual guarantees, buy back agreements and insurance.

(ii) **Approach 2** – This approach would determine lessor lease classification as Type A or Type B in the same manner as Approach 1. However, if the classification of the lease as a financing was achieved based on third party involvement (i.e., residual value guarantees, buy-back agreements, or insurance), the lessor would be precluded from recognizing selling profit and revenue at lease commencement, rather, the lessor would recognize the selling profit through interest income over the term of the lease. In order to recognizing selling profit at lease commencement under this approach, the lease would have to transfer control to the lessee using sale criteria that will be in the Revenue Recognition standard.

(iii) **Approach 3** – An approach that would determine lessor lease classification (Type A vs. Type B) based on the lessor's business model.

The Vote: The majority of the IASB favor Approach 1 while the FASB and several IASB board members favor Approach 2. However, when asked, eight members of the IASB indicated they could support Approach 2 in the interests of convergence (the IASB requires the affirmative vote of nine members to issue a standard).

Commentary: The fact that there was not a converged view is not troublesome as the difference in approaches is not that great meaning a compromise may be achieved. It was interesting to note that the business model approach was not discussed at all. The ELFA favors the business model approach but would also support Approach 1 as we believe lessor sale treatment should include third party arrangements re the residual asset as well as the terms of the lease. Although the ELFA does not agree with Approach 2 it is more acceptable than the lessor models in the Exposure Draft.

Lessee Small-Ticket Leases: With the objective of providing relief in applying the leases guidance to small-ticket leases held by a lessee, the following alternatives were discussed:

(i) Providing explicit materiality requirements within the leases guidance.

(ii) Permitting the leases guidance to be applied at a portfolio level.

(iii) Providing an explicit recognition and measurement exemption for leases of small, non-specialized assets (a "sub-set" of small-ticket leases).

The Vote:

(i) Neither Board favored providing explicit guidance to define a materiality exemption; rather, a lessee should judge materiality of leases as they would any other transaction.

(ii) The IASB favored specifically allowing a portfolio approach to simplify accounting for leases while the FASB did not on the basis that a portfolio approach is always available to a lessee provided that they can demonstrate that the results reported are substantially the same as if the standard was applied on a lease by lease basis.

(iii) The IASB favored allowing an exemption for small, non-specialized assets, regardless of the total value while the FASB did not citing the overall objective of capitalizing leases and that this exemption could result in many leases that add up to a significant value remaining off balance sheet. The FASB chairman asked the FASB staff to research the volume of leases involving assets that might qualify for this exception before trying to determine if there is any way for the FASB and IASB to reach a converged answer. The FASB Vice Chairman asked that the assessment also include assets included in PP&E that might fall within the scope of this exemption due to the possibility that a company that owns such assets could enter into a sale-leaseback transaction and avoid recognizing any financing obligation for the lease.

Lease Term (Renewal Options) and Purchase Options: The Boards discussed:

(i) Whether to retain the term ”significant economic incentive” to define if a renewal option or purchase option should be included in lease payments and in the determination of the lease term. The intention of the provision is that “significant economic incentive” is a high threshold and is it intended to have the same meaning and results as current practice.

(ii) Whether to require reassessment of the lease term and purchase options or not require reassessment at all. If reassessment is required, should it be based on a lessee controlled event or both a lessee controlled event and other factors related to the lease and leased asset?

The Vote: Both Boards favored continuing to use the term “significant economic incentive”, that it is intended to be a high hurdle and equivalent to current GAAP. They decided to use the term “reasonably certain” (instead of reasonably assured, the term used in US GAAP) in the guidance to reinforce that it is a high hurdle but also consistent with current GAAP. Both Boards agreed to require reassessment. Both Boards agreed that the triggering event should be restricted to actions that the lessee takes or is in control of and not other events.

Commentary: The intent is to clearly define the hurdle to cause an option to be included in lease payments and that the hurdle is high and the same as in current GAAP. The intention is to limit reassessment to only when events that the lessee controls occur. This means lessees do not have to review all leases for reassessment every time they report results to the public.

Lessee Accounting: Short-Term Leases: The Boards discussed:

(i) Should the definition of short term lease be lengthened beyond 12 months?

(ii) Should the definition of short term exclude leases with any option to renew or only renewal options where the lessee has a significant economic incentive to exercise?

(iii) Should short term lease disclosures be restricted to merely reporting current year rent expense, rent expense plus further explanatory details if lease expense is not representative of the commitments related to the short term leases, or rent expense plus include committed short term lease payments in the disclosure of lease commitments?

The Vote: The Boards decided not to extend the term to longer than 12 months for determining if a lease is exempt due to its short term nature. The Boards voted to use the newly decided definition of lease term to determine if a lease is a short term lease for purposes of applying this exemption. That is, if there is no economic incentive to exercise renewals, a one year lease with renewal options would meet the short term lease exemption. The Boards decided to disclose rent expense re short term leases as well as explanatory information if the commitments arising from short term leases are not evident to users.

Commentary: The intention of the decisions is to simplify compliance and increase the number of leases that would be exempt from capitalization while still providing useful information to users.