Feature

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The Ever-Changing Lease Exposure Draft

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) jointly released an exposure draft (ED) titled *Leases* and proposed an accounting model that would significantly change lease accounting. The objectives of this ED, released on Aug. 17, 2010, were to converge International Financial Reporting Standards (IFRS) with the U.S. Generally Accepted Accounting Principles (GAAP) and develop an improved standard on lease accounting.

The proposed model has significant business implications, including impacts on contract negotiations, financial ratios, business systems and processes. The ED addresses both lessee and lessor accounting issues, but the focus of this article is primarily on lessee accounting.

The ED requires a lessee to recognize its rights and obligations under all leases – existing and new – on its balance sheet. Lessors would report leases using either a performance-obligation approach or a de-recognition method. The Boards reversed their position and tentatively decided on a Receivable and Residual lessor accounting model in their deliberation in July 2011. The ED requires lessees to estimate the lease term and contingent payments at the beginning of the lease and reflect them on their balance sheets. The lessees should also reassess these assets and liabilities subsequently throughout the term of the lease and adjust them accordingly.

The Boards received over 770 comment letters in response. The comment period ended on Dec. 15, 2010. The Boards also reached out to users and preparers in different countries and held several roundtable discussions. Many respondents expressed concern about the technical complexity of the guidance as well as its practical application and its costs and benefits.

CURRENT U.S. GAAP

FASB issued Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, codified under Accounting Standard Codification Topic 840 (ASC 840) in 1973. The guidance requires lessees to

	Assets	Liabilities	Off-BS Liabilities	Lease Expenses	Amortization Expenses	Interest Expense	Total Expense
Operating Lease (ASC 840):							
Year 1 Beginning	$- (1)	$- (1)					
Year 1	$-	$-	$12,000 (2)	$12,000 (4)	$-	$-	$12,000
Year 2	$-	$-	$- (3)	12,000 (4)	-	-	12,000
Year 3	$-	$-	$-	12,000 (5)	-	-	12,000
Total				**$36,000**	**$-**	**$-**	**$36,000**
Capital Lease (ASC 840):				========	=======	=======	======
Year 1 Beginning	$22,676 (1)	$22,676 (1)					
Year 1	$11,338 (2)	$11,619 (3)	$-	$-	$11,338 (5)	$ 943 (6)	$12,281
Year 2	$- (2)	$- (3)	$-	-	11,338 (5)	381 (6)	11,719
Year 3	$-	$-	$-	12,000 (4)	-	-	12,000
Total				**$12,000**	**$22,676**	**$1,324**	**$36,000**
"Right-to-Use" ED:				======	=======	======	======
Year 1 Beginning	$33,036 (1)	$33,036 (1)					
Year 1	$22,024 (2)	$22,562 (3)	$-	$-	$11,012 (4)	$1,527 (5)	$12,539
Year 2	$11,012 (2)	$11,618 (3)	$-	-	11,012 (4)	1,056 (5)	12,068
Year 3	$- (2)	$- (3)	$-	-	11,011 (4)	382 (5)	11,393
Total				**$-**	**$33,035**	**$2,965**	**$36,000**
				======	=======	======	======

Operating Lease (ASC 840):
(1) No assets or liabilities are recognized under ASC 840 operating leases.
(2) The gross amount of lease obligations in Year 2. Companies usually disclose their off-BS liabilities in a footnote to their financial statements.
(3) Option to renew the lease is not considered a liability or an off-BS liability under ASC 840.
(4) Contractual lease payments.
(5) Renewal option lease payments.

Capital Lease (ASC 840):
(1) Reflects the present value of lease payments for 24 months.
(2) Prior year book value less current year amortization.
(3) Prior year balance less $12,000 lease payments plus current year interest.
(4) Renewal option lease payments.
(5) Straight-line amortization of asset for a useful life of two years.
(6) Interest expense for Year 1 and Year 2.

"Right-to-Use" ED:
(1) Reflects the present value of lease payments for 36 months.
(2)Prior year book value less current year amortization.
(3)Prior year balance less $12,000 lease payments plus current year interest.
(4)Straight-line amortization of asset for a useful life of three years.
(5) Interest expense for Year 1, Year 2 and Year 3.

classify all leases at the inception date as either a capital lease or an operating lease. A lease is a capital lease if it meets any one of the following criteria; otherwise, it is an operating lease:

- Transfer of ownership. The lease transfers ownership of the property to the lessee by the end of the lease term.
- Bargain purchase option. The lease contains a bargain purchase option.
- Lease term. The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
- Minimum Lease Payments. The present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property.

In an operating lease, the lessee reflects the lease rentals in the statement of operations on a straight-line basis. In a capital lease, the lessee measures the liability based on the estimated lease term at the present value of the estimated future lease payments, discounted using the lessee's incremental borrowing rate or, if it cannot be readily determined, the rate the lessor charges the lessee.

The current lease accounting model has often been criticized for failing to meet the needs of the users. The financial information between different entities is not comparable under this model as "bright-lines" – the 75 percent and 90 percent rules – for lease capitalization are arbitrary and encourage contract manipulation. The "off-balance-sheet" liabilities distort the balance sheet of the lessees. Financial analysts commonly adjust financial statements for "off-balance-sheet" liabilities to achieve comparable results between entities.

THE EXPOSURE DRAFT

The main goal of the ED was to ensure that assets and liabilities related to lease contracts are reflected on the balance sheet. The ED impacts the statement of operations as well as the balance sheet. The straight-line rent expense in existing guidance will generally be replaced by amortization of the "right-of-use" asset and interest expense on the lease obligation. The interest expense will be front-end loaded (similar to

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mortgage amortization). Furthermore, the interest expense, unlike the lease expense, will be reflected as other expenses rather than as a component of operating expenses and cost of sales. Therefore, for a set of comparable data, the operating result or gross margin under the ED would be higher than the current U.S. GAAP guidance.

At the inception of the lease, the lessee measures the liability based on the estimated lease term at the present value of the estimated future lease payments, discounted using the lessee's incremental borrowing rate or, if that rate is not readily available, the rate the lessor charges the lessee. A "right-of-use" asset is recognized at lease commencement for an amount equal to the liability plus any rent that the lessee has prepaid and any recoverable initial direct costs that it has incurred.

The Boards concluded that this measurement approach would be more practicable than a strict fair value measurement and would reasonably approximate the fair value of the property. The recognition of assets and liabilities under the proposed guidance is essentially the same as the accounting treatment for capital leases under ASC 840.

The ED also requires that lessees subsequently reassess estimates of the lease term and contingent rent and reflect the result in their balance sheets. This process imposes a significant administrative burden to companies.

Finally, the ED does not grandfather any of the lessee's existing leases. As a result, companies need to assess and record all existing leases under the proposed model at the time of adoption and for any comparable periods presented. Clearly, this requirement imposes significant administrative burden to companies as well.

Under the proposed "right-of-use" model, lessees are required to estimate the lease term and periodically reassess that estimate. The estimated lease term is defined as "the longest possible term that is more likely than not to occur." Estimated future lease payments are determined using a probability-weighted expected outcomes approach and would include estimates for contingent rentals, residual value guarantees and termination option penalties. As we will discuss, the Boards reversed their position on this matter and replaced the criterion of "probable-weighted outcome" with "significant economic incentive."

After the initial recognition and measurement, the "right-of-use" asset is amortized on a systematic basis (generally straight-line) using the pattern of the lessee's consumption of the "right-of-use" asset's economic benefits from lease commencement over the shorter of the lease term or the useful life of the underlying property. The expense is reflected in the lessee's statement of operations as amortization rather than rent expense. The "right-of-use" asset is also subject to impairment under the applicable standards.

The lessee's liability under the ED is measured at amortized cost every period using the interest method under which lease payments are apportioned between interest expense and a reduction of the remaining lease liability. The interest calculation is based on the effective interest method, which is calculated based on a declining principal basis. This method results in front-loading of the interest expense in the statement of operations of a lessee.

Some of the key implications of the ED on lessees are as follows:

- recognition of "right-to-use" assets and liabilities in balance sheet;
- recognition of additional contingent liabilities in balance sheet;
- impact on balance sheet key ratios and any lessee's covenants; and
- impact on statement of operations by front-loading the interest expenses and changing the geography of expenses within the statement of operations.

SUMMARY OF THE COMMENTS RECEIVED

The Boards received over 770 comment letters. Many respondents expressed concerns about the technical application of the standard as well as its practical application and its costs and benefits. The following is a summary of some of the major and still outstanding issues:

- Many of the constituents were concerned about acceleration of expenses compared to existing operating lease accounting and the timing of cash payments. Many of the respondents questioned the usefulness of the proposed model.
- There were also concerns among the respondents regarding the complexity and administrative burden of the proposed guidance.
- Although many respondents agreed that some extension option and contingent payments should be accounted for and reflected as pseudo liabilities and corresponding pseudo assets in the balance sheets, they were concerned about the subjective nature of such judgments and the requirement for periodic reassessment of contingencies. There were a variety of opinions on this issue and it will remain a major discussion topic in coming months.

THE DISCUSSION PAPERS AND DELIBERATIONS

The Boards issued a project update in March 2011 that revised the ED based on the comments that they received. The Boards decided to postpone consideration of lessor accounting issues because most of the criticisms of the proposed ED were directed at lessee accounting.

The Boards tentatively agreed to account for all short-term leases by not recognizing lease assets or lease liabilities and by recognizing lease payments in the statement of operations on a straight-line basis over the lease term. Therefore, short-term leases will be treated like operating leases under ASC 840. A short-term lease is a lease that at the date of commencement has a maximum possible lease term – including any options to renew or extend – of 12 months or less.

The Boards tentatively decided to identify a principle for categorizing two types of leases for both lessees and lessors, with different impact on statement of operations:

- a *finance lease* with a profit or loss recognition pattern consistent with the proposals in the ED;
- an *other-than-finance lease* with a profit or loss recognition pattern consistent with an operating lease under existing IFRS and U.S. GAAP (ASC 840).

Those leases that are primarily financing transactions would have a recognition pattern similar to a financed purchase, as proposed in the ED. Leases that are not primarily financing in nature, on the other hand, would have a recognition pattern more closely aligned with ASC 840 straight-line lease accounting.

Furthermore, the Boards, in their April discussions, tentatively decided that there should be a fundamental distinction between those leases that are primarily financing transactions in nature and those that are not. The Boards tentatively agreed to use indicators similar to those in International Accounting Standards (IAS) 17, *Leases*, as the basis for distinguishing between the two categories of leases. IAS 17 defines a lease as a finance lease if it transfers substantially all risks and rewards incident to ownership to the lessee, and all other leases are classified as operating leases. IAS 17 requires that the classification be made at the inception of the lease. [IAS 17.4]

However, in their latest deliberations in May 2011, the Boards were unable to achieve a consensus for an approach to straight-line expense recognition for leases. As a result, they agreed to a major reversal on their earlier decision in April 2011. The Boards decided that lessees should apply the finance lease approach to all leases recognized on the balance sheet. Therefore, under this view, only one type of lease exists for lessees and expense recognition pattern would be consistent with the treatment of capital leases under the current ASC 840 lease accounting practice and the original ED proposal.

The above provision would require a lessee to recognize interest expense using the effective interest method and separately amortize the right-of-use asset (generally on a straight-line basis). The expense recognition pattern generally would result in higher total periodic expense in the earlier periods of a lease and lower total periodic expense in later periods and is consistent with what the ED proposed and the treatment of capital leases under current lease accounting.

In April 2011, the Boards tentatively defined the lease term as the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease. Therefore, in a major reversal from the tentative decisions reached in February 2011, "more likely than not" and "probability-weighted expected outcomes" were replaced by "significant economic incentive."

In May 2011, the Boards reversed their previous tentative decision again and required that options for extension of leases must meet a much higher threshold (such as reasonably assured) to be included in the amounts recognized on the balance sheet.

The Boards revisited certain aspects of accounting for contingent rent in their April discussions. They tentatively agreed that contingent payments that are usage or performance based (e.g., tenant sales based) would not be considered in measuring the lease asset and liability unless the contingent payments are "in-substance" fixed lease payments (i.e., anti-abuse provision).

LATEST DEVELOPMENT

FASB and IASB announced on July 22, 2011, that they are planning to re-expose their proposed leasing standard. The tentative re-deliberation decisions made by the Boards to date represent significant changes from the proposals in their August 2010 ED, therefore warranting re-exposure. The Boards plan to publish a revised exposure draft for public comment in the fourth quarter of 2011, with a final standard by mid-2012.

ILLUSTRATION

In Figure 1, Entity A (the lessee) enters into a two-year lease agreement with option to renew the lease for an additional year. Entity A has a significant economic incentive to exercise this option. The monthly lease payment is $1,000 per month and the incremental borrowing rate of Entity A is 6 percent per annum. There is no purchase option and the residual value of property at the end of year three is nil.

This illustration reflects the front-loading of expenses under the ED proposal and different geography of expenses under the ED and ASC 840. The total expense, however, remains the same under different guidance presented.

FURTHER DELIBERATIONS

The Boards do not have complete and final thoughts on lessee accounting at this time. Some questions remain to be resolved and are subject to further deliberations. Their plan to re-expose the proposed guidance and continue with deliberations and outreach is an indication that the Boards intend to issue a quality standard and are cognizant of the views of their constituents.

A complete summary of the Boards' deliberations on the leases project is available on FASB's website at www.fasb.org or IASB's website at www.ifrs.org. ■

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