## The New Rules: FASB vs. IASB

*What are the differences?*

*By Bill Bosco, Leasing 101*

The lease accounting change project began as a joint project with an objective of converging on a worldwide set of rules. The idea of convergence was dropped when the FASB and IASB took different views on whether all leases were the same for lessee accounting. They did continue to meet jointly and the rules are not too far apart in most areas. The major objective of capitalizing most operating leases was achieved. This article will identify key differences (FASB ASC Topic 842 vs. IASB IFRS 16) that impact lessors and their structuring of leases to meet customer objectives and comment on the implications of the differences.

**Lessee accounting model**

Both models require operating leases to be capitalized as an asset and liability measured at the present value of the lease payments as newly defined. Topic 842 recognizes the substance of leases for lessees, that is, operating leases, being executory contracts, do not create a debt obligation or ownership of the leased asset as a finance/capital lease does. As a result the basic accounting and presentation principles of FAS 13 are retained – the ROU (right of use) asset and lease liability are separately reported and the liability is labeled an operating liability (not debt), the P&L cost is the straight line average rent. IFRS 16 treats ***all*** lessee leases as finance/capital leases (the operating lease liability ***is*** considered debt and the P&L cost is front ended).

***Business implications:*** *All lessees will want the lowest amount capitalized as ROA will deteriorate due to the addition of the new capitalized operating lease assets. There are structuring opportunities created by the new rules definition of lease payments to be capitalized that can be used by lessors to lower capitalized lease payments and as a result reduce the value of the capitalized asset (less negative impact to ROA). I will cover those ideas in future articles. Operating lease classification will continue to be important to FASB companies as the lease liability is not debt (less impact to financial ratios, measures and covenants) and the lease cost is straight line (not front loaded as for IASB companies). Operating lease classification may even be important to IASB companies if they need to break out the operating vs, finance lease balance sheet amounts to give information to regulators, lenders or other users. I have commented on this issue of added compliance complexity to the IASB and in other articles I have written to no avail – IASB company CFOs will probably end up having to keep a second set of records.*

IFRS 16 has a lessee recognition and measurement exemption for leases of assets with values of less than $5,000. The Topic 842 Basis for Conclusions (BC122) allows adoption reasonable capitalization thresholds below which lease assets and liabilities are not recognized. This would be consistent with many entities' accounting policies in other areas of GAAP (for example, in capitalizing purchases of property, plant, and equipment).

***Business implications:*** *Small ticket lessors will benefit. The IASB lessee automatically get this benefit. FASB lessors may point out the ability to set a reasonable capitalization policy to allow the exemption to continue to account for small item leases off balance sheet as operating leases.*

**Lessor accounting model**

IFRS 16 does not distinguish between sales-type and direct financing leases; therefore, IFRS 16 permits recognition of selling profit on sales type/direct financing leases at lease commencement even if third party residual insurance is used to convert an operating lease to a sales type lease. Topic 842 follows the new concept of what qualifies as a sale in the Revenue Recognition standard. This means that third

party involvement like a third party residual guarantee or residual insurance to achieve finance lease classification will not result in sale treatment/recognition of selling profit at commencement even though its classification has been converted. Instead a lessor would be allowed to account for the finance lease by amortizing the unearned income, including the selling profit, over the lease term via an implicit rate that reflects the cost as the present value rather than the fair value. Said differently the implicit rate used will be very high.
***Business implications:*** *FASB manufacturers/dealer lessors who need residual insurance to achieve sales type gross profit recognition under current rules will suffer under the new rules with a deferral of revenue and the gross sales profit will be reported on a different line – for operating leases it will appear on the income statement as reduced depreciation expense and for finance leases it will appear as additional lease revenue/interest revenue. The longer the lease terms the more severe the P&L issues because it is a timing difference that will take longer to turnaround the longer the lease term. Lessors will have to weigh the options (the issues involve where the profit shows up in the P&L (geography) and when it shows up (timing)). They may record a selling profit by selling the asset to a third party lessor or non-consolidated joint venture partnership but continue to service to stay close to the customer and participate in re-marketing to capture some of the upside. They may stop buying the insurance and accept the consequences of operating lease treatment. They may buy the insurance and have a more accelerated revenue pattern than operating leases and then sell/transfer the receivables to generate a gain on sale of the receivables, although it will be reported as other income. There are also income tax issues with each of the above choices not dealt with in this article.*

**Variable lease payments**
Both sets of rules change the definition of payments to be capitalized by lessees to include variable payments based on a rate (like LIBOR) or an index (like CPI) based on the "spot" rate and only the amount expected to be paid under a residual guarantee (current rules would include the full amount of the residual guarantee as a lease payment). IFRS 16 requires reassessment (re booking) of variable lease payments that depend on an index or a rate when there is a change in the cash flows resulting from a change in the reference index or rate (that is, when an adjustment to the lease payments takes effect). Topic 842 only requires re booking of variable lease payments that depend on an index or a rate when a lease is modified, there is change in variable lease payments caused by a lessee's actions that permanently changes future payments, or a significant event or change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.
***Business implications:*** *This means, in general, that FASB lessees will not have to re book a lease with variable payments based on a rate or index unless something that the lessee is in control of causes lease payment assumptions to change. FASB lessors may choose to create structures with variable rents based on a rate or index and structures with residual guarantees that have lower "fixed" payments in exchange for the variable payment or residual guarantee. There are tax issues regarding residual guarantees. There are risk issues with variable rents structures. I will write future articles to expand on these ideas.*

**Sale and leaseback transactions**
Both sets of rules do not allow sale treatment in a sale leaseback that allows a fixed purchase option in the leaseback. The FASB ***will*** allow a fair market purchase option to not negate sale treatment only if there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.
***Business implications:*** *The fixed price purchase option negating sale treatment is an issue that lessors and lessees will have to deal with in the logistics of the sale leaseback. If the lessee is merely acting as an agent, in effect putting the lease participants together (lessor and original seller of the asset), then*

*the lease* ***can*** *have a fixed price non-bargain purchase option and still qualify as a sale (operating lease back). I would seek legal advice in documenting the fact the lessee is an agent in the transaction. Transactions with a long construction/acquisition process like an aircraft need special attention in determining when, in the process, the lessee is considered the owner. I would seek advice of the lessee's audit firm in advance. The other option is to create the "agent "documentation before ordering the asset or committing to purchase. The "alternative asset readily available" fair market value purchase option allowed by the FASB is a high hurdle and the issue should be cleared by the lessee's auditor in advance. It won't work for real estate (they specifically state that all real estate is unique) but it should work for non-specialized equipment (anything that has a used equipment market).*

**Conclusion**

There are other issues where there are differences in the sets of rules, transition and impairment as examples, which do not have business implications for lessors in structuring leases to meet customer needs. In any case lessors should understand the rules changes in detail so that they understand changed lessee business concerns and how they should or may adjust their product offerings. New Rules = New Ideas and Opportunities!

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