



Lease Accounting Project Update

October 3, 2011

Executive Summary

Timeline:

- Target is Q1 2012 for a new Exposure Draft with a 120-day comment period
- This means the new rules will not be issued until late in 2012
- Transition date 2015 or thereafter

Lessee Accounting:

- Capitalize all leases @ the PV of estimated payments
- P&L pattern front ended – rent expense replace by amortization and imputed interest
- Lease term = substantially the same as current GAAP definition
- Variable rents based on a rate (i.e. Libor) or an index (i.e. CPI) are booked based on spot rates with review and adjustment at every reporting date. Variable rents based on usage or lessee performance (e. g. sales) not booked unless a tool to avoid capitalization (disguised minimum lease payment). Estimated payments under residual guarantees are booked with review and adjustment at each reporting date.
- Short term leases use operating lease method with additional disclosure TBD.

Lessor Accounting:

- Three methods approved – 1)“Receivable & Residual” (R&R) method (much like current GAAP direct finance lease method), 2)short term lease (current GAAP operating lease method) and 3)investment properties measured at fair value for qualifying real estate leases
- Equipment leases will generally use the R&R method (direct finance-like method)
- Under the RR method assets are the PV of the receivable and a plugged residual
- Sales-type gross profits are limited with residual portion of gain deferred until resolved
- Leveraged lease accounting is eliminated with no grandfathering. This is a FASB-only issue. New leveraged leases may be allowed offsetting of the rent & debt service (TBD). The Boards will not allow tax affected revenue recognition for any lease.
- Short term lease use operating lease method

Details

Item	Commentary
Re-exposure – A new exposure draft will be issued around year end or early in 2012 with a 120 day comment period.	This is good news as it allows the industry and its lessee/customers another chance to comment. The main problem areas are lessee front-ended lease costs and the loss of leveraged lease accounting.
Issuance Date - Likely to be late 2012	
Effective Date - Tentatively decided as 2015 or perhaps 2016, depending on pace of re-deliberations by the Boards	Likely to 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, the Boards are <u>considering</u> 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 may be worded so that leases of intangibles like software can be accounted for as leases by analogy.
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	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

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).

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.

leases.).

<p>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.</p>	
<p>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.</p> <p>The lessee must use the new, current incremental borrowing rate to adjust for changes in estimates of the lease term. Other changes in estimated payments would not require a change in the discount rate.</p>	<p>Adjusting the lessee discount rate reintroduces a high level of complexity and volatility in reported results. They did say they would re-look at the issue of the lessee discount rate in future meetings. The good news here is there are fewer instances where the lease term will be changed due to the high threshold for estimating the lease term. There also is hope that they will view renewals and extensions as new leases thus eliminating the need to adjust the existing lease to in effect make it a longer lease with P&L implications of front ending the renewal costs into the base lease term.</p>
<p>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).</p>	<p>This is an extremely unpopular decision with lessees and many users of financials (analysts). It will have unintended consequences regarding contracts and regulations that allow cost reimbursement for rent as rent expense will be eliminated. This is an important issue that they have not resolved. 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, lease 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. They are also overly concerned with financial engineering of leases to avoid the front ending of lease costs. They also do not</p>

	<p>want to acknowledge that there are 2 types of leases – rental contracts and capital leases. Their favored solution is to not account for the former operating leases differently than the former capital leases is to disclose the amount of cash rent paid and the amount of rent expense that would have been reported in the reporting period. It is also inadequate for analysts as it does not break out capital leases from former operating leases and because it does not give retrospective information for adjusting equity and deferred taxes.</p> <p>Additionally, any time a lease is terminated early there will be a gain. This is not logical and points out the fact that lease costs are recognized too early.</p>
<p>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.</p>	<p>There is some confusion as to what was said at their recent meetings but the staff assures us 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, the Boards decide that a renewal or extension is a new lease to avoid complex adjustments, but that remains to be seen.</p>
<p>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.</p>	
<p>Purchase Options – The Boards decided the exercise price of a purchase option</p>	<p>These conclusions are consistent with their conclusions on the lease term and</p>

<p>should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments <i>only</i> when there is a <i>significant</i> 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.</p>	<p>renewals so it is good news except for the concerns re: frequency and details of reassessment in practice.</p>
<p>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:</p> <ul style="list-style-type: none"> - An option to extend or terminate a lease, and -An option to purchase the underlying asset. <p>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.</p> <p>The Boards tentatively decided that changes in lease payments that are due to a reassessment in the lease term should result in:</p> <ul style="list-style-type: none"> - 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 	<p>These conclusions are consistent with their conclusions on the lease term and renewals so it is good news except for the concerns re: frequency and details of reassessment in practice.</p>

<p>loss (pending the Boards' decision on lessor accounting).</p>	
<p>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:</p> <ul style="list-style-type: none"> - 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. When the index changes the lease has to be adjusted. The P&L is "hit" for the current and prior period impacts and the ROU asset and liability are adjusted for the future impacts. - 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. - Disclosure will be required within the notes of contingent rent leasing arrangements (details to be determined later). 	<p>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.</p> <p>The changes re: variable rents based on usage and lessee performance are 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.</p>
<p>Residual Guarantees –The Boards reiterated their conclusions that:</p> <ul style="list-style-type: none"> - a third party residual guarantee is not a minimum lease payment for the lessor. - 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 	<p>The decision that a residual guarantee is not a minimum lease payment is not good news as it may limit sales type lease profits recognized up front. It also means the guaranteed residual is not a financial asset that can be securitized off balance sheet.</p> <p>In our opinion, the charges regarding changes in the estimate of the amount payable under a residual guarantee should be allocated to future periods, meaning offsetting entry to the change in the lease liability is an increase or decrease in the ROU asset and the new balance in the</p>

<p>events or circumstances indicate that there has been a significant change;</p> <ul style="list-style-type: none"> - 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. <p>For lessors a residual guarantee or residual insurance will not be recorded until the residual is resolved nor will it convert the residual asset to a financial asset. It will be a determining factor in the analysis of whether a lessor's profits are reasonably assured. It will not affect gross profit recognition.</p>	<p>ROU asset is straight lined over the remaining lease term.</p> <p>Further, a guaranteed residual should be labeled a financial asset and it should increase gross profit recognition.</p>
<p>Short Term Leases - The Boards will allow short term leases by asset class election to use the current operating lease method. This applies to lessors and lessees.</p> <p>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.</p>	

<p>Lessees are required to disclose rental expense incurred under short-term leases during the reporting period and whether there are circumstances or expectations that would indicate that the entity's short-term lease practices would result in a material change in the next reporting period</p>	
<p>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.</p>	<p>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.</p>
<p>Contract Modifications or Changes in Circumstances after the Date of Inception of the Lease - The Boards tentatively decided:</p> <ul style="list-style-type: none"> -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. 	

<p>-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.</p>	
<p>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.</p>	<p>This is good news as it simplifies the lessee accounting. They are discussing including committed leases in the footnote table of future lease obligations. This adds to the complexity of compliance.</p> <p>At this point, the Boards have not concluded that a renewal is a new lease so if a renewal is executed before the end of a lease term or a lessee determines that there is a significant economic incentive to renew, the renewal is booked before commencement – clearly this is not logical as a new lease is not booked until commencement. The fact that lease costs are front loaded means the lease costs from the renewal period will begin to be recognized during the remaining term of the original lease. As a result it would be in the lessee’s best interest to terminate a lease and sign a new lease. In termination the lessee would record a gain on the old lease. This would somewhat offset the front ending of costs in the new lease.</p>
<p>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.</p>	<p>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.</p>
<p>Lease Incentives - Cash payments received from the lessor are included as a cash inflow in the cash flow discounting to</p>	

determine the value of the right-of-use asset and capitalized lease obligation.	
<p>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.</p>	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.
<p>Initial Direct Costs - These are third-party costs that are directly attributable to negotiating and arranging a lease, which would not have been incurred had the lease transaction not been made. 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.</p>	
<p>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.</p>	
<p>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.</p>	

<p>Lessee Disclosures</p> <ul style="list-style-type: none"> -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 	<p>The lessee disclosures are more extensive than current GAAP. The proposed disclosures do not give users enough information to reconcile the proposed P&L and cash flow presentation to what would have occurred under current GAAP. The issue of how to determine rent that is reimbursable under regulatory and contract reimbursement is unresolved.</p>
<p>Lessor Accounting Model - The Boards decided that there will be one lessor accounting method for all leases called the Receivable Residual" ("R&R") method.</p>	<p>The decision to use one basic lessor model is good news for equipment lessors. The R&R method is very similar to the current direct finance lease method.</p>

<p>There are two 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 sales type profit is allowed 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.</p> <p>The above gross profit recognition under the R&R method is available only if the profit in the lease is “reasonably assured”. This should not be an issue for equipment leases as the considerations to decide if profits are reasonably assured are uncertainty about the residual value, uncertainty regarding the split between executory costs in a lease with services and uncertainty about the fair value of the leased asset at inception.</p> <p>Leveraged lease accounting will not be included in the new rule. The Boards will not allow grand fathering of existing deals. They will not allow a tax affected revenue recognition method. 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, but this is not assured.</p>	<p>Allowing partial sales type profit on all leases is good for the former operating leases but worse for the former direct finance leases. The decision to accrete the residual is important good news. The failure to label a guaranteed residual as a financial asset is an issue for transfers of financial assets and gross profit recognition. It is likely that manufacturers and dealers will use more third party lessors to provide leases to customers so they can maintain the same level of profitability as under current sales type accounting rules. This will mean the costs to lessees will increase and 3rd parties may not approve all the credits that a captive would thereby tightening availability of credit,</p> <p>The news on leveraged lease accounting is bad for the industry and the cost to lessees. The cost of capital will rise for leveraged lease portfolios which is particularly bad for bank lessors. The cost of leases will rise for all the lessees of large ticket assets that would have been candidates for leveraged leases as alternative structures are not as cost effective.</p>
<p>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</p>	<p>This potential decision to limit investment properties accounting to investment companies 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</p>

must fair value the residual asset. The proposal under discussion will allow this only if the leasing company is an investment company. This is as opposed to IAS 40, which already exists for IAS companies and allows the accounting method for all real estate leasing companies in addition to having the fair value residual accounting as an option.	company as it is then subject to all the aspects of investment company accounting.
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Conclusion - It appeared that the industry (both lessees and lessors) would fare very well in the Boards' deliberations after issuance of the original Exposure Draft in August 2010. Unfortunately, subsequent actions by the Boards negated and/or revised those initial favorable tentative decisions. It appeared the rules would be simpler and closer to current GAAP on the lessee side, but they re-introduced accelerated P&L costs and eliminated expense rent. The decision to adopt one lessor method – the R&R method – is good news except for the limiting of sales-type profit recognition. The loss of Leveraged Lease accounting is unfortunate for lessors and lessees. It looked like the comment letter process would favorably influence the FASB and IASB from the industry's perspective. Unfortunately, that is not now the case. Industry participants should continue to monitor the project closely and provide comments when the ED is issued later in 2012.

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