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Technical topics in leasing
Are all leases created equal?

Investment property is different

John Hepp, Partner, Accounting Principles Consultation Group and **Mark Scoles**, Partner in Charge, Accounting Principles Consultation Group

As the Financial Accounting Standards Board (FASB) continues its deliberations on the leasing project, some important issues have been raised about the proposed accounting models for both the lessor and the lessee. In this paper, we look at one of the fundamental issues: Is there a single accounting model that faithfully represents the economic substance of all leases? The original proposed FASB Accounting Standards Update, *Leases*, issued in August 2010, included two models for lessors. The International Accounting Standards Board (IASB) and the FASB (the Boards) decided on a single approach for lessors during redeliberations but subsequently decided to "scope out" leases of investment property, creating a de facto second model. Once again, the issue is on the table: Are all leases created equal? This paper looks at the issue from the perspective of the business model of the lessor. "Business model" is sometimes a term of derision in accounting circles, but it can be a useful means of comparing two transactions to determine whether the economic substance of the transactions is the same.

This paper looks at the issue, beginning with the lessor. Subsequent papers will look at the issue from the perspective of the lessee.

Background

In the United States, leases are a flexible contractual means of sharing risk between consenting parties. Under existing GAAP, this is reflected in two accounting models:

- **Capital lease accounting**, for situations in which substantially all the risks and rewards of ownership have been transferred from the lessor to the lessee. The lease is in substance a purchase.
- **Operating lease accounting** for all other leases. The lease is in substance an executory contract between the lessor and the lessee. In accounting vernacular, the lease is off-balance sheet.

The main criticism of this accounting dichotomy is the ease with which it can be abused: The explicit criteria for recognizing a capital lease provide a road map for how to structure arrangements so that lessees qualify for operating lease accounting. Some critics, however, object to any distinction at all between capital and operating leases because they believe that all executory contracts should be recognized on the financial statements, preferably at fair value, and that operating leases are an excellent place to start.

How you see the problem will affect how you see the solution. If the issue is abuse, one solution would be to revise the criteria. This could be done by, for example, lowering the bar for capitalization from substantially all of the risks and rewards to a simple majority of the risks and rewards. Alternatively, the Boards could adopt a model with indicators based on transfer of control of the underlying asset, as has been proposed in the revenue recognition project. If the issue is unrecorded executory contracts, then there is no need to have criteria at all. One would simply recognize an obligation for future lease payments and a corresponding contract asset.

For the lessee, the Boards have proposed a right-of-use model that is a hybrid form of the executory contract model. Future payments that relate to an underlying asset would be capitalized. Future payments for related services would continue to be accounted for as executory contracts. This may not satisfy those who favor recognition of executory contracts because only part of the future payments would be recognized.

A single model… with exceptions

For the lessor, the proposed solution from the Boards eliminates the distinction between capital and operating leases but does not adopt either approach as the new unified accounting model. The proposed solution is the receivable and residual approach, which reclassifies the underlying asset as two new assets: a receivable for the present value of the future minimum lease payments, and a residual, which represents the asset to be returned by the lessee at the end of the lease term. Leases are accounted for similarly to a partial sale or a sale with a partial right of return (of a future residual interest), instead of as a sale of the underlying asset or as an executory contract. Profit is immediately recognized for that portion of the underlying asset transferred to the lessee. The economic substance of the lease is defined as a sale of the right-of-use asset for the duration of the lease term and a related financing.

The Boards did incorporate some exceptions into the proposed model. Short-term leases will continue to be accounted for as executory contracts as a "practical expedient," i.e., because the amounts are immaterial or because the accounting would be unduly burdensome, but not because there is anything different about the economic substance of a short-term lease. The IASB also made an exception under IFRS for leases of investment property that is accounted for at fair value (an option not yet available under U.S. GAAP). During redeliberations, the Boards received feedback arguing that the receivable and residual model would not be practical to implement for many leases of real estate. The Boards therefore decided to extend that exception to all leases of investment property regardless of whether the leased assets are accounted for at amortized cost or at fair value.

We believe that the proposed exceptions to the model for investment property and short-term leases are indicators that there is a difference between the economic substance of certain leases that is not related to the term of the lease, the nature of the property, or whether the lessor accounts for the property at amortized cost or at fair value. Instead, the exceptions may be reflecting different lessor business models.

One model or two?

The single-model approach considers all leasing transactions to be financing arrangements. Reality is more complicated. Lease contracts are a flexible legal means of sharing risk between a lessor and a lessee.

Managing financial assets

A lessor may engage in financing with varying amounts of exposure to credit risk, interest rate risk and perhaps residual risk, but little or no exposure to other risks associated with ownership, such as obsolescence, price risk or other market risks. The lessor is extracting value from financial assets. The lessor may or may not retain any residual risk: :

- If the lessor is primarily managing financial assets and does not retain the residual risk by, for example, obtaining a residual guarantee from the lessee or a third party, then the lease is in substance a sale and financing. The lessor, however, may have an obligation to perform remarketing services at the end of the lease term, which may be a separate performance obligation. In that case, the lease would be a multiple-element arrangement.

- If the lessor is primarily managing financial assets but retains the residual risk, the lessor engages in two profit-making activities: lease financing of new equipment, and remarketing of used equipment.

These types of business models are commonly employed for many, but not all, equipment leases.

Managing operating assets

A lessor may also be engaged in multiple ongoing business processes in association with a group of operating assets, such as marketing efforts to secure customers and ensure full utilization, inventory management, maintenance and security. Assets may be managed for their entire economic life. Some assets, especially real estate, may be held for appreciation as well as for income.

So there are two potential, but very different, business models: a financing model and an operating model. What are the financial reporting implications of the differences between the two models?

In a financing model, the lessor is typically managing risks associated with financial assets with a limited number of processes involving nonfinancial assets. Accordingly, the balance sheet of a financial lessor should reflect the nature of the assets the lessor manages and the risks retained. Although we are still waiting to see the details, our understanding of the receivable and residual model is that it is meant to describe the lease financing business model.

In an operating model, the lessor typically is managing more processes associated with nonfinancial assets, including processes for finding customers, maintaining property, providing security and performing other services. The lessor usually manages more risks, including risks of idle assets and obsolescence, not typically found in the financing model. In substance, the leases are more like executory contracts than financial instruments. The balance sheet of an operating lessor should also reflect the nature of the assets the lessor manages and the risks the lessor retains. That does not mean that the arrangements should be off-balance sheet. It means that the recognition and disclosure requirements should be consistent with those for an executory contract rather than a financial instrument.

The question then becomes: Will a single accounting model faithfully represent the economic substance of all leasing arrangements? As tempting as it is to search for a single model that will prevent structuring (or, depending on your point of view, limit judgment), we do not believe that a single model can provide relevant information that faithfully presents the underlying economics of all leasing transactions in the financial statements.

Examples: Extracting value from financial assets

The following are examples of business models in which the lessor is managing a financial asset and may or may not be managing residual risk. The proposed receivable and residual model may capture the economic substance of these transactions because the lessor is primarily managing a financial instrument.

- Equipco Manufacturing engages in leasing transactions for equipment that it manufactures. Typically leases run for three years. Most customers do not renew the lease or purchase the leased equipment. At the end of the lease term, the equipment is refurbished and sold in the used equipment market where Equipco is a dealer. Pricing of the lease includes estimated proceeds from sales of used equipment.
- Leaseco is a lease financing company that offers lease financing options to customers of various manufacturers. Leaseco does not engage in market activities. At the end of the lease, lessees may purchase or remarket the equipment. The lessee typically is responsible for any shortfall in residual value and may participate in any gains. The lease is priced based on prevailing interest rates for similar lessees and collateral.
- Customco engages in build-to-suit real estate leases in which Customco purchases designated real estate and constructs buildings such as retail outlets or restaurants to the lessees' specifications. Leases are generally for 20 years or more, with two five-year renewal options. Customco also holds the land (but sometimes not the improvements) for appreciation. The lease is "triple-net," i.e., the lessee is responsible for all operating costs including maintenance, insurance and taxes. The lease is typically priced based on prevailing interest rates for similar lessees and collateral.

Examples: Extracting value from operating assets

The following are examples of business models in which the lessor is managing operating assets and related processes, as well as residual risk. The proposed receivable and residual model would probably not capture the economic substance of these transactions because of the lessor's management of operating assets and related business processes.

- Rentco is a car rental facility that typically rents cars for periods of one day up to three months. Rentco actively seeks customers and has facilities in airports, resorts and major urban centers. Rentco also provides maintenance and road service. The cars are refurbished and sold at auction after two years of service. Rental rates are based on factors such as market, competition, duration and season.

- Railco leases railcars with an expected life of up to 60 years for periods of three, five and seven years. Some of the leases are full-service leases where Railco provides maintenance and other services. At the end of the lease term, Railco typically refurbishes cars and seeks other lessees. Rates are primarily determined by supply and demand.

- Officeco owns office buildings in major urban centers and rents space with leases of five to 10 years, usually renewable at market rates for additional five-year terms. Officeco maintains the exterior of the building, common areas and elevators, and maintains the heating and air-conditioning systems, common plumbing, wiring and other infrastructure. Officeco holds the buildings for rental income. Officeco plans to hold some of the prime properties indefinitely. Others may be sold if the circumstances are favorable. Rentals are primarily determined by the vacancy rate in the particular market and the desirability of the location.

How do we tell the difference?

Telling the difference between the two types of leases is an issue that has bedeviled standard setters for generations. Clearly the current GAAP, which tries to draw a distinction based on the transfer of substantially all of the risks and rewards, is not working. We agree that the model needs updating; however, we respectfully disagree with the Boards' proposal to replace the current GAAP model with a single model and somewhat arbitrary exceptions. The central issue is not the nature of the underlying asset, but whether the lessor is managing financial assets or operating assets, and what types of risks are inherent in the lessor's business model. An arbitrary one-year cutoff for executory contract accounting is not the answer either.

What next?

With the advantage of hindsight, lessor accounting might have benefited from a broader analysis in a Discussion Paper instead of moving straight to an Exposure Draft. Clearly, more work remains to be done. We suggest that future research focus on the business model of the lessor to determine the risks retained by the lessor and whether the lessor has retained substantive control over the underlying asset or has transferred that control to the lessee with the right of use. We believe that significant differences in the business models may warrant different measurement attributes, revenue recognition and, especially, disclosures. How to subsequently measure executory contracts and the appropriate level of disclosure remain open issues of importance to the users of the financial statements. •

Additional resources

- AICPA: FASB/IASB – Leases FAQs
- Grant Thornton: *New Developments Summary*, "FASB and IASB express views on accounting by lessees"

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