Key Lessee and Lessor Decisions Made in the Leases Project June 2012

Overview/Timeline

The FASB and IASB Boards met June 13, 2012 in London and made key decisions on lessee and lessor accounting in their Leases Project. Although they finally decided all leases are not alike, they made a split decision as to how to classify them based on the type of asset leased. **The decision presents challenges for most equipment lessees and, possibly, for lessors.**

This was the last major decision-making meeting of the joint Boards (there will be one more meeting in July) on the project prior to issuance of a revised Exposure Draft (ED). The timeline for the project is:

- Last decision-making meeting regarding remaining (minor) issues in July 2012,
- Draft ED in third quarter 2012,
- Issue ED fourth quarter 2012 with 120-day comment period,
- Review comments letters and revise ED if necessary in first half 2013
- Issue final standard in second half 2013
- Effective date would be 2016 or later to allow lessees and lessors time to develop systems, extract lease data and prepare comparative financials under the new models.

Analysis

Although the Boards were spilt, with the FASB favoring a two-lease model and the IASB favoring a one-lease model, they took a second vote on whether compromise was possible to get a converged standard. In the second vote, the majority agreed they could compromise on a two-lease model approach for both lessees and lessors with the same dividing line to determine which accounting approach to use. **The ELFA has been advocating a two-lease approach since the outset of the Leases Project in 2006.**

The two lessee approaches (with an exception for short-term leases to use the existing operating lease model) are:

- The Right of Use (ROU) approach (now called Approach 1) where the lease is capitalized and the asset is amortized straight line and interest is imputed on the liability. The result is a front ended expense pattern.
- The Whole Contract approach (now called Approach 2) where the asset and liability are capitalized, then adjusted each month to equal the PV of the remaining payments. The P&L is straight line as the average rent is accrued each month and the actual rent paid is charged to the accrued rent payable account.

The two lessor approaches (with an exception for short term leases) are

- The Receivable and Residual) (R&R) method
- The Operating Lease method (same as current GAAP in FAS 13)

The dividing line will be a newly created notion in which real estate and equipment leases are treated differently.

- For equipment leases, it is presumed that the lease is an ROU lease for lessees and an R&R lease for lessors unless the lease term is an insignificant portion of the economic life of the underlying asset or the present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset**. This new line is vastly different than under existing GAAP and for legal and tax purposes, causing more equipment leases to have front-ended costs and causing equipment lessees to keep records under the existing rules.**
- For real estate leases, it is presumed the lease is a Whole Contract lease for lessees and operating leases for lessors unless the lease term is for the major part of the economic life of the underlying asset or the present value of fixed lease payments accounts for substantially all of the fair value of the underlying asset. This line is virtually the same as the line under existing GAAP.

It should also be noted that leases that are viewed as financed purchases by the Revenue Recognition Project will ***not*** be considered leases. Control of the underlying asset is the principle employed so leases with automatic transfer of title or bargain purchase options will be considered financings – not leases. This means that, for those transactions, capital lease accounting will be used by lessees, and lessors will use sale and loan accounting. **The ELFA supports the view that the Revenue Recognition standard define what lease contracts are financed purchases versus leases (i.e., merely a transfer of the right of use) and let the Leases standard apply to lease accounting.**

Commentary

The ELFA believes:

- It is good that the Boards decided on a two-lease model for lessees as it should be closer to the economics of leases in that some leases transfer ownership rights while others merely transfer a right of use. Those that only transfer a right of use are executory contracts that should result in a cost pattern that is level and the liability is not classified as debt in bankruptcy. **The big problem for equipment leases is the new line to classify leases is vastly different than under current GAAP and will not reflect the economics of most equipment leases.**
- Equipment lessees will not support the idea of a different dividing line than the existing FAS 13/IAS 17 as that line is part of the current federal tax, property tax and legal systems. The current lease classification GAAP process is closer to the widely accepted "risks and rewards" approach. **Lessees will have to keep two sets of records to prepare their tax returns and to show potential lenders which leases survive bankruptcy as assets and debt using existing capital leases accounting concepts that will remain in the tax and bankruptcy rules.**
- Lessees will have a more difficult task of classifying leases under the proposed "line" as there is more judgment than under FAS 13. The proposed "line" is now based on a judgment as to whether the lease term or PV of the rents is ***insignificant*** whereas the current FAS 13 tests are the opposite. That is, is the lease term or the present value of lease payments ***significant*** compared to the useful life and fair value of the underlying leased asset? More equipment leases will have front-ended costs. The difference in the outcomes may not likely be significant in terms of the cost patterns, which begs the question why change the "line" when the current classification process is well understood, requires less judgment and is part of the fabric of business and regulations in the US..
- US lessors advocate a two-lease model with financial lessors using the R&R methods and operating lessors using the operating lease method. Symmetry is not appropriate as lessees and lessors have different views of the lease transaction. US equipment lessors who are financial lessors will generally view the current decision as an improvement over current GAAP (except for the loss of leveraged lease accounting, excluding ITC from revenue recognition in non leveraged leases and changes to sales-type profit recognition) only for the reason there will be fewer operating leases. Real estate and full service and short/medium

term equipment lessors also favor the decision only for the reason that they can keep using the operating lease method. .

- The true nature of the impact of these decisions will not be fully known until the staff and Boards complete the drafting of the Exposure Draft.