



## Lease Accounting Project Update & Commentary

July 2012

The IASB and FASB convened a key decision-making meeting on June 12, 2012. They are close to completing all work needed to write a new Exposure Draft (ED). The following project update represents key provisions likely to be included in the new ED. Decisions made since the February meeting of the Boards are in ***bold italics***:

- ***Slippage in the issuance of the new Exposure Draft to year end 2012, final rule slipping to 2014 and transition year slipping to 2017***
- ***They finally decided there are two types of lessees for both lessors and lessees:***
  - o ***For lessees, they propose a straight line rent method and a front ended cost method***
  - o ***For lessors, the R&R method and the existing operating lease method***
  - o ***The short-term election remains unchanged***
- ***The classification tests to determine what lease qualifies for which method will be different for real estate leases and equipment leases so that most real estate leases will use the straight line method while most equipment leases will have a front ended cost pattern. This is not good news for the equipment leasing industry.***
- ***There will be symmetry between lessee and lessor lease classification, which is good news for real estate lessors and superficially is good news for equipment lessors as there will be fewer operating leases for them***

## Executive Summary

### *Estimated timeline*

- Target is **year-end 2012** for a revised Exposure Draft with a 120-day comment period
- This means the new rules likely will not be issued until **2014**
- Transition date **likely to be 2017**

### **Lessee Accounting**

- Capitalize all leases @ the PV of estimated payments.
- Some leases will have a** P&L pattern that is front ended – rent expense replace by amortization and imputed interest. **Some leases will have straight line rent expense. Real estate leases are presumed to get straight line expense unless the lease term and PV of rents are meet similar tests as current GAAP while equipment leases are presumed to get front ended costs unless the lease term and PV of rents are insignificant compared to the useful life and fair value of the leased asset. Insignificant remains to be defined.**
- 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 adjustments booked when the rate change changes contractual lease payments. 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, including most short term renewals, can elect to use operating lease method with additional disclosure.

### **Lessor Accounting**

- **Two methods identified for lessors** – The “receivable & residual” (R&R) method (much like the current GAAP direct finance lease method) for leases of the entire asset to one lessee (***covers virtually all equipment leases***), and ***existing operating lease accounting which will cover most real estate leases***. There is a short term lease election to use current GAAP operating lease method. ***The classification tests will be the same as those for lessees (see above). They dropped the investment properties issue for real estate lessors. This appears to be good news except if they change their minds on 2 different lines for lessees yet maintain symmetry, equipment lessors will have more operating leases without the ability to use residual insurance to change the accounting.***
- 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 be deferred until resolved.
- Leveraged lease accounting is eliminated with no grandfathering. This is a FASB only

issue.

## Details

Item	Commentary
<p><b>Re-exposure</b></p> <p>A new exposure draft will be issued <i>near year end 2012</i> with a 120- day comment period. <i>In mid-2013, the Boards will review comment letters and decide on which issues to re-deliberate for the balance of 2013. They will likely not issue the new standard until 2014.</i></p>	<p>This is good news as it allows the industry and its lessee customer another chance to comment. The main problem areas are <i>treating equipment leases differently than real estate leases for lessee accounting resulting in few equipment leases getting straight line rent expense; symmetry in lease classification for lessees and lessors;</i> the deferral of gross profit in sales-type leases; <i>the failure to treat a guaranteed residual as a financial asset for the lessor;</i> the loss of leveraged lease accounting and complexity/compliance costs.</p> <p>Readers and lessee customers should read the new exposure draft when issued and send a comment letter to the FASB/IASB.</p>
<p><b>Effective Date of New Standard</b></p> <p>- <i>Most likely 2017</i></p>	<p>Preparers will have to show two years comparative data in the year of transition for all leases on the books in the year of transition. In other words, there will be a need for information under the new rules for 2014 or 2015, depending on the transition year decided upon.</p>
<p><b>Lessee &amp; Lessor Transition Methods</b></p> <p>– For lessees:</p> <ul style="list-style-type: none"><li>- Capital leases are grand fathered</li><li>- Operating lease leases - obligation booked at PV of remaining rents, offsetting ROU asset booked but adjusted by the ratio of remaining rent to total rents at inception and the difference is charged to equity and deferred tax assets</li><li>- Existing sale and leaseback</li></ul>	<p><i>The transition methods may be changed as they came up with a new lessee straight line subsequent accounting method that deals with the front loading issue and they re-introduced operating lease accounting for lessors yet did not re-address transition.</i></p> <p><i>It is important to note that real estate lessees will be happy with the decision as they will get straight line rent expense as the lease cost for most leases. There are two unknowns in</i></p>

transactions:

Sale and leaseback transactions that resulted in capital lease classification are grandfathered, including continuing to amortize any deferred gain or loss on sale over the lease term in the statement of comprehensive income.

- For a sale and leaseback transaction that resulted in operating lease classification or the sale recognition criteria previously were not met, a seller/lessee would reevaluate the sale conclusion based on the criteria for transfer of control of an asset in the proposed revenue standard. If the criteria were met, a seller/lessee would measure lease assets and lease liabilities in accordance with the Boards' previous tentative decisions regarding transition for leases that are currently classified as operating leases and would recognize any deferred gain or loss in opening retained earnings upon transition to the new leases guidance.
- Alternatively, a seller/lessee may elect to apply the requirements in the proposed leases standard retrospectively.
- For lessors
  - Direct finance leases and sales type leases are grandfathered
  - For operating leases **that are R&R leases under the new lease classification tests** book the PV of the rents as an asset, derecognize the operating lease asset and the difference is the residual. No decision on how to handle transition for operating leases with a gross profit element **that would now be R&R leases under the new standard.**
  - **Use operating lease accounting for operating leases that**

**transition for individual real estate sale leasebacks. One is whether the sale will be still considered a sale under Rev Rec if there is a purchase option in the leaseback (if not a sale then the leaseback is treated as a loan so the P&L cost is front loaded). The other issue is whether the leaseback will qualify for straight line P&L due to the length of the lease term versus the useful life or the PV of the payments versus the fair value of the property.**

For lessee's using the optional full retrospective transition method will smooth the lessee transition year P&L impact **for leases with front ended costs** 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 in the year of transition. 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.

For lessees **with leases with front ended costs** the proposed modified retrospective approach would start the new accounting method for the lease liability for each lease (as though it were a new lease for the remaining term) beginning in the earliest period presented when a lessee converts. The ROU asset is adjusted in a complicated way by using a ratio of remaining rents to total rents to reflect a partial retrospective result. This is an attempt to lessen the first year P&L cost front ending. Instead the charge from this depreciation adjustment is to equity and deferred tax assets rather than to current P&L. This is an additional complexity for the lessee. This means that existing leases will have a front ended pattern almost as though they were new leases but with a term equal to the

<p><b><i>continue to meet the operating lease classification tests.</i></b></p> <p>Early adoption will be allowed for IFRS preparers and first time IFRS adopters.</p>	<p>remaining term. The difference between this new method and treating the existing leases exactly as though they were new leases is the charge to equity and deferred tax assets – still not an outcome that reflects the economics of a lease to the lessee. This method will still create large increases in reported lease costs until the lessee’s lease portfolio reaches a point where an equal amount of expiring leases are replaced by new leases. At that point the front ending phenomenon leaves all lessees with a permanent reduction in equity and a permanent deferred tax asset. In a going concern that is growing and with inflation there the portfolio of leases will grow and the lessee company will never reach a point of steady state leases costs.</p>
<p><b>Scope</b></p> <p>All leases of a “specified asset,” which includes leases of explicitly or implicitly identifiable property, plant and equipment as under current GAAP but also “inventory items” such as spare parts.</p>	<p>Although it excludes intangibles the scope may be worded so that leases of intangibles like software can be accounted for as leases by analogy.</p> <p><b><i>Any lease where the lessee is deemed to have control, as defined by the Revenue Recognition Project, of the underlying leases asset is out of the scope of the leases project. Presumably those will be leases where there is an automatic transfer of title in the leased asset or where the lease terms include a bargain purchase option. Those transactions will be accounted for as financed purchases of the underlying asset.</i></b></p>
<p><b>Definition of a lease (need to distinguish from service contract)</b></p> <p>Regarding leases vs. installment purchases, the Boards decided to eliminate the scope exclusion therefore all lease contracts should be accounted for in accordance with the leases standard. Guidance will not be provided in the leases standard for distinguishing a lease of an</p>	<p>The tension in the definition of the lease is due to the fact that all operating leases are to be capitalized. Under current GAAP, full service leases that contain an operating lease element and a service element are accounted for in the same manner – that is as off balance sheet executory contracts. There needs to be a crisp definition to avoid capitalizing more contracts than intended (for instance there is no intention to capitalize any portion of an outsourcing</p>

underlying asset from a purchase or a sale of an underlying asset. If an arrangement does not contain a lease, it should be accounted for in accordance with other applicable standards (for example, property, plant, and equipment).

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.

contract where it is difficult to identify specific assets employed to deliver the service).

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 leases.). They did away with the EITF 01-08 grandfathering of contracts booked before May 2003 so some long term contracts that were formally exempt from lease accounting may now be covered and capitalized.

<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><b>Rates for lessee and lessor accounting</b></p> <p>- 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&amp;L. Lessors use the implicit rate in the lease to calculate the PV receivable and to accrue revenue. For the residual revenue, the rate used in leases with no gross profit element, the implicit rate is used. For leases with a gross profit element, the accretion rate is derived (details are TBD)</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 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&amp;L implications of front ending the renewal costs into the base lease term.</p>
<p><b>Lessee P&amp;L pattern</b></p> <p><i>The Boards decided that there are 2 types of leases:1) those that get straight line rent expense, and 2) those that are considered a purchase of a right of use and a financing so that the combination of ROU asset amortization and imputed interest creates a front loaded cost pattern.</i></p> <p><i>The Boards decided that the classification tests to determine whether a lease gets straight line or front ended expense are different for real estate leases and equipment leases as follows:</i></p> <p><i>The dividing line is a newly created idea where real estate and equipment leases are treated drastically differently.</i></p> <ul style="list-style-type: none"> <li><i>For equipment leases it is</i></li> </ul>	<p><i>The reason the Boards reversed their view is so they could break the impasse over lessee accounting that was preventing the issuance of a converged ED. Our view is that the same principles that apply to real estate lease transactions should also apply to equipment leases. The different line appears to be an arbitrary decision to get a desired answer that may not be seriously challenged in the comment letter process.</i></p> <p><i>The proposed straight line method for most real estate leases will favor real estate lessees and may result in fewer comment letters by them.</i></p> <p><i>The proposed front loaded P&amp;L cost pattern will be an extremely unpopular</i></p>

<p><b><i>presumed that the lease is a front ended cost lease for lessees and an R&amp;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 still keep records under the existing rules for tax compliance purposes.</i></b></p> <ul style="list-style-type: none"> <li>• <b><i>For real estate leases it is presumed the lease is a straight line method 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.</i></b></li> </ul>	<p><b><i>decision with equipment lessees</i></b> 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 has not been resolved.) It will eat up capital and profits for banks and other lessees. It will create large 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. <b><i>Since the current FAS 13 classification tests are the based on the same risks and rewards concepts as in the UCC code, bankruptcy laws, personal property taxes and income taxes lessees will have to maintain records under existing GAAP for legal and tax compliance.</i></b></p> <p>The Boards are concerned with financial engineering of leases to avoid the front ending of lease costs. They should focus on the fact that the unit of account is the contract and its fair value is the important balance sheet value – both the ROU asset and lease liability should have the same value over time except for impairment and initial direct costs (<b><i>that means straight line rent expense for all leases that are not financings of the underlying asset</i></b>). Additionally, due to the front loading of lease costs, 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 prematurely.</p>
<p><b>Lease term</b></p> <p>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</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</p>



<p>the current GAAP definition.</p>	<p>be considered a minimum lease payment to be capitalized. Hopefully, they decide that a renewal or extension is a new lease to avoid complex adjustments, but that remains to be seen.</p>
<p><b>Termination Option Penalties</b></p> <p>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><b>Purchase options</b></p> <p>They decided the exercise price of a purchase option should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments only when there is a "significant 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>.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><b>Reassessment of Options in a Lease</b></p> <p>The Boards discussed how lessees and lessors should reassess whether a lessee has a clear economic incentive to exercise:</p> <ul style="list-style-type: none"> <li>- An option to extend or terminate a lease, and</li> <li>-An option to purchase the underlying</li> </ul>	<p><b><i>The fact that most real estate leases get straight line expense will lessen the complexity of adjustments due to changes in variable payment assumptions and other assumptions. Equipment leases that use the front ended method will still be subject to complex adjustments when</i></b></p>

<p>asset.</p> <p>The Boards tentatively decided that a lessee and a lessor should consider whether it has a clear 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"> <li>- A lessee adjusting its obligation to make lease payments and its right-of-use asset; and</li> <li>-A lessor adjusting its right to receive lease payments and any residual asset, and recognizing any corresponding profit or loss (pending the Boards’ decision on lessor accounting).</li> </ul>	<p><b><i>assumptions change.</i></b></p> <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><b>Variable payments</b></p> <p>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"> <li>- All variable lease payments that depend on an index (e.g. CPI) or a rate (e.g. LIBOR based floating rate leases) must be</li> </ul>	<p><b><i>The fact that most real estate leases get straight line expense will lessen the complexity of adjustments due to changes in variable payment assumptions. Equipment leases that use the front ended method will still be subject to complex adjustments when assumptions change.</i></b></p>

<p>estimated and booked using the spot rate. . When the index changes the lease has to be adjusted. The P&amp;L is “hit” for the current and prior period impacts and the ROU asset and liability are adjusted for the future impacts.</p> <ul style="list-style-type: none"> <li>- 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.</li> <li>- Disclosure will be required within the notes of contingent rent leasing arrangements (details to be determined later).</li> </ul> <p>For lessors, when the rate charged to the lessee reflects an expectation of future variable lease payments, as actual variable payments are received that are different than estimated, the residual must be adjusted. If the variable payments were not expected, they are accounted for as revenue when received/earned.</p>	<p>This still means complexity for floating rate equipment leases, like fleet leases.</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>The requirement for lessors to adjust the residual in variable payment leases where there was an expectation of receipt of such payments is another example of over complicating the standard with situations that rarely occur or generally are immaterial.</p>
<p><b>Residual Guarantees</b></p> <ul style="list-style-type: none"> <li>-The Boards reiterated their conclusions that: <ul style="list-style-type: none"> <li>- a third party residual guarantee is not a minimum lease payment for the lessor.</li> <li>- 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;</li> <li>- residual guarantees should be reassessed when events or circumstances indicate that there has been a significant</li> </ul> </li> </ul>	<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. <b><i>Now that they decided on symmetry with lessee accounting it may be more important to retain the ability to treat a residual guarantee as a minimum lease payment so that the</i></b></p>

<p>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 events or circumstances indicate that there has been a significant change;</p> <ul style="list-style-type: none"> <li>- 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.</li> </ul> <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 not affect gross profit recognition.</p>	<p><b><i>lessor can change an operating lease into an R&amp;R lease. This will be important if they decide to change the lessee lease classification line as that could mean more operating leases for lessors</i></b></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 ROU asset is straight lined over the remaining lease term.</p> <p>In our opinion, a guaranteed residual should be labeled a financial asset and it should increase gross profit recognition.</p>
<p><b>Short term leases/renewals</b></p> <p>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</p>	<p>The decision to allow operating ease accounting for short term renewals where the lessor and lessee have the right to terminate with no significant penalty is good news. It means simple off balance sheet accounting for lessees.</p>

<p>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>Month-to-month renewals where both the lessee and lessor have the right to terminate with no significant penalty are considered short term leases eligible for the operating lease accounting election.</p>	
<p><b>Subleases</b></p> <p>- A head lease and a sublease should be accounted for as separate transactions. The lessee accounts for the head lease by capitalizing the ROU asset and liability and following <b>either the front ended or straight line method</b>. The lessor accounting for the sublease must follow decisions on lessor accounting.</p>	<p><b><i>Although they did not discuss subleases, the decision to allow most real estate leases to use the straight line method for lessees and the operating lease method for lessors should be good news for real estate sublessors. It should mean the P&amp;L will show rent expense and rent income with the same pattern. Equipment lease subleases that do not qualify for straight line accounting will remain complex. Subleasing of equipment leases is not common so it should not be a big issue, but applying the R&amp;R method to a sublease will be difficult.</i></b></p>
<p><b>Sale leasebacks</b></p> <p>If the transaction is considered a sale under the revenue recognition standard (means that control of the asset has been transferred – there is a question of control transfer when a purchase option is included in the lease) 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</p>	<p>The questions of the interplay between the leasing rules and the Rev Rec ED are unresolved. The presence of a purchase option may mean that the sale leaseback is considered a financing (no gain recognized up front).</p> <p>The transition rules are bad news for the banks that did sale leasebacks to raise capital. Not only will the asset come back on books but the P&amp;L cost <b>may be accelerated if the leaseback does not qualify for straight line accounting.</b></p>

<p>value, the assets, liabilities, gains and losses should be adjusted to reflect the current market.</p> <p>In transition any deferred gains in existing sale leasebacks will be credited to equity.</p>	<p>Also the deferred gain will not flow thru earnings but rather be a credit to opening retained earnings.</p>
<p><b>Contract Modifications or Changes in Circumstances after the Date of Inception of the Lease</b></p> <p>-The Boards tentatively decided:</p> <p>-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 <b><i>in any lease with a front ended pattern of accounting for the lease costs (there will be no gain for lease under the straight line method).</i></b> A new lease would then be recorded.</p> <p>-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>	
<p><b>Lease inception vs. commencement</b></p> <p>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 they have not concluded that a renewal is a new lease so if a renewal is executed before the end of a lease term or is 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. <b><i>In those leases with lease costs are front loaded</i></b> it means the</p>

	<p>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><b>Pre-commencement payment/interim rents</b></p> <p>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 for lessees and as a result, lessees will be more aware of the cost of the lease. For lessors, 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><b>Lease incentives</b></p> <p>Cash payments received from the lessor are included as a cash inflow in the cash flow discounting to determine the value of the right-of-use asset and capitalized lease obligation.</p>	
<p><b>Bundled lease payments</b></p> <p>Payments must be bifurcated by lessees and lessors. Lessees 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>	<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>
<p><b>Initial direct costs</b></p> <p>These are costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.</p>	

<p>These are third party costs.</p> <p>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><b>Foreign Exchange Differences</b></p> <p>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><b>Impairment</b></p> <p>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><b>Lessee presentation and disclosures</b></p> <p>On the balance sheet the lessee must present the ROU asset with PP&amp;E based on the nature of the underlying asset either separately or by providing a breakdown in the notes. The lease liability may be presented separately on the balance sheet or disclosed in the notes. On the income statement the lessee will present amortization of the ROU asset separately</p>	<p><b><i>For front end cost lease</i></b> the presentation in the income statement and cash flows statement will not reflect the economic effects of leases. The current GAAP straight line rent expense and rent reported as an operating cash outflow provide more useful information. These issues are a consequence of the decision to create the front loaded cost pattern.</p> <p>The lessee disclosures are more extensive than current GAAP. The proposed disclosures do not give users enough</p>



from the implied interest on the lease liability. Interest on the lease liability must be reported separately from other interest expense. On the statement of cash flows the implied principal payment is considered a financing activity and the implied interest, variable rent costs and operating lease rents are considered cash outflows from operating activities.

Disclosures include:

- 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

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>liability and right-of-use asset, and short-term lease expense.</p> <ul style="list-style-type: none"> <li>-Separately disclose the cash paid relating to the lease liability.</li> <li>-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.</li> </ul>	
<p><b>Lessor accounting model</b></p> <p><i>–The Boards decided there must be symmetry with lessee accounting so the same lessee lease classification tests for real estate and equipment leases will apply for lessors.</i></p> <p><i>The Boards decided that there will be two lessor accounting methods: the “receivable residual” (“R&amp;R”) method and the existing operating lease method. There are is an exception for short term leases as they can be accounted for under the current GAAP operating lease method if so elected. The assets under the R&amp;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 book value. The residual is accreted to its estimated value at lease expiry using the implicit rate in the lease.</i></p> <p>Under the R&amp;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. .</p>	<p><i>This decision means that most equipment leases will be R&amp;R leases which is good news for financial lessors. Although if we win the argument that equipment leases and real estate leases should be treated the same, it would mean more equipment leases will be operating leases (we think the lessor lease classification should be based on business model – financial lessors use the R&amp;R method while operating lessors use the operating method).</i> The R&amp;R method is very similar to the current direct finance lease method. 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 <b>for lease classification</b>, transfers of financial assets and gross profit recognition. Manufacturers and dealers may 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 may mean the costs to lessees will increase and 3<sup>rd</sup> parties may not approve all the credits that a captive would thereby tightening</p>

<p>Leveraged lease accounting will not be included in the new rule. They will not allow grand fathering of existing deals. They will not allow a tax affected revenue recognition method.</p>	<p>availability of credit</p> <p>The news on leveraged lease accounting is bad for the industry. 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><b>Investment Property Accounting for Real Estate Leases</b></p> <p><i><b>This approach is moot as they are now allowing real estate lessors and operating lessors to use the operating lease method.</b></i> 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 must fair the residual asset. The proposal in 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 that allows the accounting method for all real estate leasing companies in addition to having the fair value residual accounting as an option.</p>	<p><i><b>This is a non issue now that real estate and operating lessors can use the existing operating lease method.</b></i></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 company as it is then subject to all the aspects of investment company accounting.</p>
<p><b>Lessor presentation and disclosure</b></p> <p>The lease receivable and the residual asset are presented separately in the statement of financial position, summing to a total “lease assets”; or combined as “lease assets but with the breakdown disclosed in the notes.</p>	<p>The lessor disclosures are extensive. For large organizations it will be difficult to comply and still provide meaningful information without a voluminous footnote. The likely result will be very general “boiler plate” statements</p>

The finance income on the rents and the residual accretion are presented as interest income net of initial direct cost amortization. Sales-type profits may be reported gross or net of cost of sales.

Disclosures required are:

- lease income generated from the entity's leasing activities (in tabular form) disaggregated by (a) profit recognized at lease commencement, (b) interest income on the lease receivable, (c) accretion of the residual asset, (d) variable lease income for amounts not initially recorded in the lease receivable and (e) short-term lease income.
- fixed-price purchase options which exist on underlying leases.
- information about variable lease payments and lease term (i.e., disclosing the basis and terms on which contingent rentals are determined and the existence and terms of options, including renewal and termination options).
- a reconciliation between the beginning and ending balances of the lease receivable and residual asset.
- a maturity analysis of undiscounted cash flows that are included in the lease receivable, with reconciliation to the amounts reported in the statement of financial position for the lease receivable. Time bands for the maturity analysis should, at a minimum, include each of the first five years following the reporting date and the total of the amounts for the remaining years.
- how it manages its exposure to the underlying asset, including:
  - o its risk management strategy;
  - o the carrying amount of the

<p>residual asset that is covered by residual value guarantees and the unguaranteed portion of the carrying amount of the residual asset; and</p> <ul style="list-style-type: none"> <li>○ whether the lessor has any other means of reducing its exposure to residual asset risk (e.g., buyback agreements with the manufacturer from whom the lessor purchased the underlying asset or options to put the underlying asset to the manufacturer).</li> </ul> <p>However, disclosure would not be required for:</p> <ul style="list-style-type: none"> <li>○ initial direct costs incurred in the reporting period and included in the lease receivable.</li> <li>○ the fair value of the lease receivable or the residual asset.</li> <li>○ the range or the weighted average of discount rates used to calculate the lease receivable</li> </ul>	
<p><b>Business Combinations</b></p> <p>Lessees: Record the lease liability and ROU as though the lease was a new lease but use the incremental borrowing rate on the acquisition date. Adjust the ROU asset if the lease rents are off market. For short term leases no entry is necessary.</p> <p>Lessors: For leases where the R&amp;R method is applicable record the PV of the rents using the implicit rate on the acquisition date. The residual is the difference between the PV receivable and the fair value of the leased asset on the acquisition date.</p> <p>For short term leases no entry is</p>	<p>Lessees will immediately report front ended lease costs as the acquired leases are considered new leases. The requirement to adjust for off market terms will be difficult to apply for equipment leases as there is no market for used equipment to get observable lease rates.</p> <p>For lessors the proposed rule makes sense as that is how a lessor will price an acquired lease.</p> <p>For securitizations of operating leases retrospectively recording the transactions as sales, if they qualify, would give the user more useful information as the alternative is to report assets that do not meet the definition of an asset.</p>

<p>necessary.</p> <p>For lessors that do not follow the R&amp;R method use existing business combination guidance.</p> <p>For securitized operating leases that were recorded as secured borrowings lessors cannot retrospectively record the securitization as a sale.</p>	
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## Conclusion

***The Boards made decisions that recognize there are two types of leases. However, the decision on the new lease classification line is not founded in principle but, rather, establishes an arbitrary approach to create a desired outcome for equipment leases, that is, to consider them financings and to front load lease costs.*** We as an industry succeeded in pointing out that the revised rules are more reasonable; but, there remain several advocacy issues:

- ***Most important is that the Boards treat equipment leases and real estate leases the same in terms of lease classification to allow straight line expense recognition for the leases that are now considered operating leases.***
- ***It is also important that lessors' business models be the basis for lessor lease classification so that financial lessors use the R&R method while operating lessors continue to use the operating lease method.***
- ***We would like the lessee lease liability to be classified as an "other" liability – not as debt.***
- ***We need clearer definitions of factors that determine the lease term and reassessment criteria.***
- ***In a sale leaseback with a non bargain purchase option, the definition of a sale in the leases project conflicts with the definitions in the Revenue Recognition project.***
- ***Lessees and lessors need relief from the complexity and compliance burden in areas like transition, adjustment of estimates in the lease term, accounting for variable rents and disclosure.***
- ***Existing leveraged leases need to be grandfathered. We support netting the rent and the debt to better reflect the economic risks for the lessor.***

***The after-tax yield argument is valid as well for leases with tax benefits but the Boards are reluctant to open up Revenue Recognition and Accounting for Income Tax rules to deal with taxes.***

- ***Regarding residual guarantees, the Boards need to recognize that residual insurance or a guarantee changes the nature of the residual to a financial asset. This is important in lease classification, gross profit recognition and transfers of financial assets.***
- ***Tax benefits should be addressed in the revenue recognized for lessors.***