Financial Reporting

Lessee Accounting: Convergence vs. Divergence

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Lessee accounting joins financial instruments as projects in which FASB and IASB diverge.

The Financial Accounting Standards Board (FASB) has published the tentative decisions on the Leases project reached at last week's joint board meeting held with members of the International Accounting Standards Board (IASB).

As noted in FASB's summary, although the two boards converged on numerous areas – one of the last of the remaining of the FASB and IASB's 'convergence' projects – they diverged in one major area: lessee accounting.

IASB board members leaned toward a model described as "Approach 1" –"a single approach for lessee accounting…[whereby] a lessee would account for all leases as Type A leases (that is, recognizing amortization of the [right-of-use] ROU asset separately from interest on the lease liability. "

In contrast, FASB board members favored "Approach 3" –"a dual approach for lessee accounting, with lease classification determined in accordance with the principle in existing lease requirements… [whereby] a lessee would account for most existing capital/finance leases as Type A leases (that is, recognizing amortization of the right-of-use (ROU) asset separately from interest on the lease liability) and most existing operating leases as Type B leases (that is, recognizing a single total lease expense)."

Is Lack of Convergence a Bad Thing?

Once upon a time, not so long ago –well, four years ago – the U.S. Securities and Exchange Commission (SEC released its Commission Statement in Support of Convergence and Global Accounting Standards (SEC Rel. No. 33-9109; 34-61578, Feb. 24, 2010) which stated, [emphasis added], " The Commission continues to believe that a single set of high-quality globally accepted accounting standards will benefit U.S. investors and that this goal is consistent with our mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation."

The SEC's 2010 statement continued, "As a step toward this goal, we continue to encourage the convergence of U.S. GAAP and IFRS and expect that the differences will become fewer and narrower, over time, as a result of the convergence project."

More recently, SEC's draft strategic plan for the years 2014-2018 released for public comment on Feb. 3, 2014, the SEC indicated a turning of the sails on the concept of a "single set" of global accounting standards, in stating, [emphasis added], "Promote high-quality accounting standards: The SEC will continue to promote the establishment of high-quality accounting standards by independent standard setters in order to meet the needs of investors. In overseeing the Financial Accounting Standards Board (FASB), the SEC will strengthen and support the FASB's independence and maintain the focus of financial reporting on the needs of investors. Due to the increasingly global nature of the capital markets, the agency will work to promote higher quality financial reporting worldwide and will consider, among other things, whether a single set of high-quality global accounting standards is achievable."

What do the FASB and IASB think of this? One could say the views expressed by leadership of the two boards on this point diverge.

During the same week in October, 2013 that FASB Chairman Russell Golden called for a 'decentralized , multi-lateral model' in remarks at a joint meeting of FEI Japan Chapter and Keidanren, IFRS Foundation Chairman Michel Prada spoke of the need for an 'inclusive, multi-lateral model' in remarks at an IFRS Foundation gathering in Germany.

More recently, IASB Chairman Hans Hoogervorst noted the two boards are diverging on some of the financial instruments standards. Specifically, Hoogervorst noted in a March 8 speech, [emphasis added] "With regard to Offsetting and most likely with Classification and Measurement the FASB in the end reverted to existing practice in the United States. We also did not manage to stay converged on Impairment, which was one of the main recommendations of the [Financial Crisis Advisory Group] FCAG. "

"This inability to deliver compatible outcomes with the FASB clearly demonstrates the inherent instability of convergence as a means to achieve a single set of global accounting standards," the IASB Chairman emphasized."

He continued, " For this reason, our Trustees wisely concluded that convergence can never be a substitute for adoption of IFRS. Thankfully, throughout the financial crisis, the momentum towards adoption has continued unabated in many countries."

Now, accounting by lessees joins certain areas of financial instruments accounting as non-converged accounting.

Returning to our question above, is that necessarily a bad thing?

FEI's Committee on Corporate Reporting: On the Record

In a supplemental comment letter filed with both the FASB and IASB on March 14, 2014, FEI's Committee on Corporate Reporting (CCR) stated **CCR's 3/14/14 letter** [emphasis added],

"At our most recent meeting, the Committee was asked to consider the question of whether it is more important for the Boards to reach a converged solution than it is for the FASB to adopt

FEI's recommended approach. Our response to that question is to observe that today's leasing models are substantially converged and could move closer together with removal of the quantitative thresholds present in US GAAP. We believe that the Boards should consider that alternative before embarking on a path that would apply Type A accounting to all lease contracts. We have doubts as to whether the latter approach is capable of becoming generally accepted."

The letter filed by FEI's CCR on this timely topic, was in fact the latest in a series of supplemental letters filed by FEI's CCR on FASB and IASB's Leases Exposure Draft, notes Lorraine Malonza, Director, Accounting Policy and Financial Research, and Staff Liaison of FEI's CCR. The original comment letter filed on the Leases ED was filed in September, 2013.

"CCR's letters on the Leases ED are the latest example of the efforts of FEI's accounting policy and advocacy committees in gathering feedback from leaders of Fortune 100 companies to inform the FASB and IASB of the views of senior-level financial executives. The comment letters filed by CCR provide a practical point of view from the people charged with implementing the standards," Malonza says.

Background on Divergence on Lessee Issue

We sought out the views of Leasing expert William J. ("Bill") Bosco, Principal of Leasing 101, on the preferability of the dual approach the FASB board settled on at the joint FASB-IASB meeting, and his views on FASB's having listened to constituents feedback on the lessee proposals in particular.

Bosco said, "I agree with the FEI [CCR] comment letter and the Display approach described in FEI's comment letters for accounting for operating leases/executory leases. In my opinion Type A accounting is only appropriate for capital leases (a financed purchase of the leased asset)."

Agreeing with the position taken in CCR's letter, Bosco said, "I do not think that reaching a converged standard for lessee accounting in more important than keeping a two lease model using the display method of accounting for operating leases."

He continued, " Forcing a Type A approach for all leases will cause US lenders and credit analysts will lose key information regarding which leases are rentals vs. financed purchases of the leased asset. Moving to IAS 17-like classification tests with no bright lines should be acceptable to the IASB as that standard, except for the fact that operating leases are not capitalized, has been working effectively around the world since 1982."

Additionally, Bosco pointed out, "Rental contracts do not creates debt obligations – most analysts say the operating lease obligations are debt-*like*, while capital leases do create debt obligations."

"I also think the FASB must align its definition of debt to the view of lenders and US commercial law. Debt should be defined as a liability that survives bankruptcy."

He continued, “The Equipment Leasing Finance Association (ELFA) and I have recommended the Display method since April 2008.”

“Further, I firmly believe that the two lease approach using the current GAAP risks and rewards framework and classification tests is the only approach that is conceptually sound as it accounts for the nature of the rights and obligations in a lease contract. The proposed Type A only approach does not distinguish between leases that transfer ownership rights (as well as rights of use) versus those that merely transfer rights of use.

“The two lease approach is the only approach that provides lenders and the majority of analysts with the information regarding leases they need to make decisions. No approach will satisfy all users but the main objective of the project is to eliminate the need for users to adjust and only the two lease approach accomplishes that.

“Additionally using the Display method and the two lease approach is much simpler for preparers. Under a Type A for all leases approach, they will have to maintain records using current GAAP’s risks and rewards framework as that is also the framework used by the US tax and legal systems. Tax compliance and bankruptcy risk analyses done by users require information based on the two lease approach. The two lease approach avoids complex deferred tax accounting that would be an added burden for most operating leases if they must be accounted for using the Type A method.”

Where do you stand on the question of convergence, and/or a whether there needs to be a ‘single set’ of standards to achieve ‘global’ accounting standards?