Lease Accounting: boards still deadlocked on several key issues

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The global accounting standard setters have this month failed to reach agreement as planned on the main lessee and lessor accounting models in the proposed new rules.

Over two recent days the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) re-deliberated these issues at their first joint decision making meeting following the second exposure draft (ED 2) issued last year.

At this stage, however, the Boards were deadlocked on several key issues. They will need to return to some of them in the months ahead. It has never seemed likely that the new standard could be finally resolved in full much before the end of this year, nor become fully effective before 2018. However, finalization seems rather further off now than before the latest joint meeting.

Lessee expensing

The most critical issue discussed this month concerned the rules for lessees' profit and loss (P&L) account expensing on what are now off-balance-sheet operating leases, when these leases (or at least many of them) come on-balance-sheet under the new standard.

In this key area the project had already moved on from the much criticized ED 2, since a preliminary discussion by the Boards in January made it clear that there was little support for keeping that exactly as it was. The Boards are now divided as between two alternatives:

- a single model for “Type A” front loaded expensing, as with current finance or capital leases, for all leases, resulting in a mixture of interest and amortization (or depreciation) expense. This was termed Approach 1 in the report by the Boards' staffs, and represents a return to the first exposure draft (ED 1) issued in 2010;
- a dual model, retaining finance and operating leases with a lease classification line close to that in current rules, again keeping finance lease accounting as it is but introducing “Type B” accounting – straight line expensing, presenting a single rental expense rather than a mixture of interest and amortization – for operating leases. This had been termed Approach 3.

Three other alternatives or variations had been identified in the staff report, including a dual model much closer to the ED 2 version with a specific split between equipment and real estate leasing. However, there was little support among Board members for any of those.

This month IASB members nearly all preferred Approach 1 while FASB members overwhelmingly went for Approach 3. For FASB this was consistent with its prevailing view since around 18 months ago, when the two Boards reached a deadlock during the long re-deliberation process between the two EDs. On the IASB side, however, there seems to have has been a shift back towards Approach 1 since the preliminary January meeting when an early compromise seemed more likely.

One influential IASB member Stephen Cooper, who in fact dissented from ED 1 in 2010 and at that stage proposed a straight line expensing model for operating leases, said this month: “Only Approach 1 really reflects the economics of a lease. I tried hard with annuity based depreciation [i.e. his earlier straight line alternative] but I do not think it was really persuasive and I am not sure that Type B gets us any closer. I do not accept the 'unit of account' argument [i.e. the Type B principle of keeping the lease asset and liability matched through the lease term]”.

Cooper argued in particular that Type A would better reflect the economics of lease structures with a heavily skewed rental profile, compared with Type B. He accepted a point made by a FASB member that the same anomaly would exist under current accounting for purchasers of pure service contracts with similarly uneven payment profiles; but he argued that this was only due to the absence of a specific accounting standard for service contracts.

Formidable

Several FASB members argued that the system challenges for lessees on operating leases in moving to Type A accounting would be formidable. This would apply especially (though not only) in respect of the transition rules for leases running at the date when the new standard first has to be applied.

However, Cooper argued that the “modified retrospective method” proposed in ED 2 went a long way towards easing the transition problem. Several IASB members felt that cost/ benefit considerations were more evenly balanced between Approaches 1 and 3 than as viewed by FASB.

There seem to be clear underlying reasons for the Boards taking different views on Type B accounting. Many ED 2 respondents from IFRS jurisdictions – notably most of the national standard setting bodies – felt that it was inconsistent with general accounting principles not to recognize interest expense on a balance sheet liability.

On-balance-sheet leases have to be discounted to a present value (or PV) when they are capitalized. Across the accounting standards as a whole, in international financial reporting standards (IFRS) there is no precedent for unwinding a PV discount except through recognizing interest. However, the same is not true of US GAAP.

One factor for FASB is that current US taxation rules for equipment leases, on the issue of whether the lessor or the lessee claims tax write-offs on the assets, are closely aligned with the current GAAP lease classification line. If lease classification disappears for lessees that would leave possible questions over the direction of US tax rules. However, since the IASB is multi-jurisdictional it makes no attempt to look at look at national tax consequences in the course of formulating accounting rules.

It may also have been significant that among corporate analysts there was a distinct territorial difference in comments on this aspect of ED2. Those based in IFRS jurisdictions were overwhelmingly in favour of Type A expensing for all or most leases, but those in the US were not.

Possible grounds for compromise

Having reached a deadlock on this issue on the first day of their two-day meeting, and made some decisions on small ticket leases (see below), the Boards returned to the expensing model issue at the end of the second day to see whether members were any more prepared to compromise for the sake of convergence.

There still seemed to be no movement on the IASB side. However, a few FASB members suggested that they might reconsider their opposition to Approach 1 if a further staff report were to show how a large proportion of small ticket leases could be scoped out. It was then agreed that the staff would report back on these issues with a view to possibly resolving the deadlock at either the April or May meeting of the Boards.

The focus of easing compliance is now on small ticket equipment leases. This is a relatively welcome development for the asset finance industry. There may nevertheless be adverse reactions among lessees in sectors making heavy use of real estate leases, such as retailing, if there were to be such a trade-off as now seems possible between small ticket leasing and the main lessee expensing model.

Respondents in those sectors to ED 1 were extremely critical of Type A expensing; and ED 2 appeared to have met these particular concerns, although many of them remained critical of capitalization in itself.

Small ticket exclusions

The Boards received a staff report on possible ways to ease the compliance burden of capitalization for lessees. This included possible exceptions focused principally on small ticket assets.

However, this month only one limited alternative of this kind was put to the vote, and that produced a split decision. In contrast with the position at the end of the joint meeting (see above), at this stage FASB members were less sympathetic to exceptions than those on the IASB, several of whom felt that the Boards needed to make some concessions to the widespread criticism of ED 2 on cost/benefit grounds.

One alternative raised in the staff report was to exclude assets that are both non-specialized and individually small. This was designed to affect only very low value office machinery like laptops and mobile phones, and office furniture. It would not have excluded business cars, nor large photocopiers.

The Boards first decided to remove the “non-specialized” criterion that the staff had suggested and just vote on small assets as such, still on this very restricted definition of size. The IASB voted in favour of this, but FASB voted against it – initially raising the possibility of a non-convergent outcome.

The staff report had had raised as possibilities, but had recommended against, two broader exceptions as follows:

• a wider “non-core asset” criterion more on the lines of those suggested by some ED 2 respondents, that could have excluded business cars and most office machinery; and/or

• excluding all aggregated leases that added up to less than a defined value limit, such as possibly 5% of total non-current assets.

However, in the light of the initial decision these wider exclusion alternatives were not put to the vote, and it seemed clear initially that they had been implicitly rejected. Similar alternatives may nevertheless reappear on a future agenda in view of the decision at the end of the meeting (see above).

Small ticket exceptions

Even at that later stage there appeared to be some differences between IASB and FASB about the appropriate basis for small ticket exceptions. FASB seemed to favour an asset value threshold that would be the same for all lessees.

On the other hand one some IASB member seemed to be thinking in terms of a “materiality” type threshold that would effectively be much higher for large company lessees than for SMEs. Cooper suggested that the threshold for capitalizing a leased asset should be up to three times higher than the threshold for capitalizing an asset owned by the same type of business (as opposed to writing off its acquisition cost as a Year 1 revenue expense).

Such issues will have to be explored in the further report now commissioned from the Boards' joint staffs.

Portfolio basis

A separate proposal in this month's staff report on small ticket compliance was the idea of a portfolio basis of accounting for those small ticket leases that would be outside the scope of any specific exclusions. This proposal would apply to both lessees and lessors, but it is potentially more important for small ticket lessees faced with all the steps involved in capitalization for leases that are currently off-balance-sheet.

The principle of the portfolio basis is that businesses could group large batches of leases together for accounting purposes if they “reasonably expect” that the result of doing this would not be materially different compared with accounting for each one individually.

For lessees it is felt that calculating the PV discount rate could be much easier on a portfolio basis, although some other compliance costs of capitalization would not be eased; and for those taking advantage of it, having to consider exactly which groups of leases could reasonably be aggregated would itself become another step in the process

The portfolio basis thus gives only limited relief to compliance costs; but on balance the Boards' staff felt that it could potentially help.

The only drawback to this as seen by the Boards was the precedent that it might create for other accounting standards. It is in fact considered implicit in all standards that a portfolio basis can be used for any type of multiple transactions, subject to the same conditions as drafted in the staff report for leasing.

The problem as viewed by some Board members is that if they make the portfolio basis explicit in some new standards (having already agreed to it in one other current convergence project), it could come to be expected as an explicit rule in every subsequent one. The impression might then be created that the portfolio basis cannot be used except where a specific standard says that it can be, which is not the standard setters' intention.

When this was put to the vote, IASB voted for it but FASB voted against it. It currently seems that these decisions will not be revisited at an early stage in the re-deliberation, and could end up being non-convergent in the final standard.

FASB members indicated that they might consider later whether to refer to the portfolio basis being permissible within their application guidance to accompany the standard. However, IASB intends to have it within its version of the standard itself.

Short term leases

The Boards did reach agreement this month on an extension of the ED 2 proposal to scope out from lessee capitalization those leases running for less than 12 months. Instead of applying only to leases that are contractually precluded from running over 12 months, this will now apply to leases that have extension options, if they would be assessed as below 12 months when applying the criteria that will be required to variable term leases, where there is to be a high threshold for recognizing continuation options (see below).

Most equipment lease or hire contracts are polarized into either very short term contracts like vehicle daily rental, which would have been within the scope of the original exception, or agreements for three years or more with no significant concessions in the case of much earlier settlement. However, the latest concession could affect some shipping charters and construction plant hire contracts, as well as a certain range of real estate rental contracts.

Within this issue there was also a decision on disclosure rules for notes to the accounts. Under existing standards these are not convergent. US lessees do not currently have to include leases with less than a year to run in the maturity analysis in the notes, but those subject to IFRS have to do so.

It was agreed generally to require disclosure only of the current year's expense on short term leases. The capital value of future obligations for the short term leases running at each reporting date will only have to be disclosed if the current year's expense is not representative of the volume of future obligations for similar leases.

FASB noted that irrespective of GAAP, in the case of public companies US financial market regulations would probably continue to require disclosure of forward obligations on short term leases. This did not, however, prevent FASB from agreeing to converge with the IASB on narrower requirements in the accounting standard that would be relevant to US private companies.

Defining the lease term

The Boards also reached agreement this month on the required recognition of the lease term, in the case of variable term leases. They had no difficulty in agreeing the principle of having a high threshold for taking account of lease continuation options, as in ED 2 (though unlike ED 1).

They then spent some time considering exactly how this should be formulated, and whether one possible form of wording might actually imply a higher or lower threshold than another. For the initial recognition of the lease term, they eventually agreed to require renewal options to be included only where they are “reasonably certain” to be exercised – thus changing the ED 2 formulation that referred to a “significant economic incentive” to renew.

The wording now agreed is identical to the IFRS version of current rules, and only slightly different from the US GAAP version which uses the words “reasonably assured”. The different wording in ED 2 was not intended to be a very material change, but some respondents felt uncertain as to the effects.

Although the wording will be virtually the same as in current standards, its impact on lessee accounting will become very much broader in the context of wholesale capitalization. For nearly all leases with truly open renewal options are operating leases, and so currently off-balance-sheet.

The Boards also agreed that asset purchase options for the lessee should be accounted for (by lessees and lessors) on the same basis as for renewal options. Therefore end-of-lease purchase options at non-bargain rates, which are common in US equipment leasing (although not in some other jurisdictions due to the effect of various tax rules) will not normally be recognized for accounting purposes at lease inception.

A more difficult issue on the lease term, which attracted a lot of critical comment on ED 2, was the question of reassessing the term at financial reporting dates while the lease is running, if any relevant factors may have changed since the initial measurement.

It was agreed that for lessees, reassessment would be required only where one of a limited number of possible triggering events had affected whether one or more outstanding optional continuation periods was reasonably certain to be taken up. These would be events under the lessee's control, such as a leaseholder's improvements to leased real estate, and would not extend to factors in the general business environment (which the staff report had suggested might be included). For lessors, there will be no reassessment requirement at all.

The main lessor model

The Boards also this month re-deliberated the main lessor accounting model. Just as with the lessee expensing model, they discussed it across both days of their meeting and failed to agree. However, on the lessor side the practical impact of the disagreement between the Boards appears extremely small. This did not prevent them from spending a great deal of time on the abortive attempt to reach agreement.

Following the Boards' preliminary discussions in January, it was clear that they wanted to move away from ED 2 and to abandon any idea of necessarily aiming for symmetry as between the lessee and lessor models. The staff report this time put up three alternative approaches. All of them were for dual models, with lessors accounting for some leases like today's finance leases, with “Type A” front loaded income recognition, and others on a straight line “Type B” basis like today's operating leases.

Two of the alternatives in the staff report were both very close to the existing rules, and the argument on the Boards was all between these two. The third option would have been to base the split of the accounting model on an interpretation of the lessor's business model, as some ED 2 respondents had suggested. However, that attracted no support from Board members.

The two alternatives were:

• “Approach 1”, exactly in line with the current IFRS version in IAS 17 - differing in a few respects from current US GAAP (principally through not having “bright line” numerical tests);

• “Approach 2”, This is exactly the same as Approach 1, except that in the case of lessees potentially recognizing up-front selling profit – in effect the manufacturer and dealer captives in equipment leasing – there would be no such profit recognition in the case (unusual in practice) where a residual value (RV) was guaranteed by a third party.

This issue has to be understood in relation to another current convergence project between the two Boards – a new Revenue Recognition (Rev Rec) standard. This too has been through two successive exposure drafts; and although the draft leasing standard started ahead of the Rev Rec project, it has since fallen behind it, and the final form of the new Rev Rec standard has now been agreed by the Boards.

Leases are specifically scoped out from Rev Rec. However, it does otherwise generally address all issues as to when the seller of any goods and services can recognize sales income.

A purchaser-focused basis

The new Rev Rec standard, unlike the ones it will replace, has a purchaser-focused basis for deciding when a sale takes place. The seller recognizes a sale when the customer has obtained control of the item sold, which is not necessarily when the seller surrenders control if a third party is involved. So in the case of captive groups selling on lease under the new leasing standard, Approach 2 would be the one more aligned with Rev Rec in the case where a third party RV guarantee (RVG) is involved.

Under Approach 1 all aspects of lessor accounting would continue to address lease classification as viewed from the lessor's standpoint. Approach 2, however, would determine the question of up-front selling profit – although not income recognition on the lease itself – according to lease classification from the standpoint of the lessee.

Where there is a third party RV guarantee (on a conventional scale of value) from outside the lessor's group, the lease is a finance lease for the lessor but an operating lease for the lessee. Thus under Approach 2 there would be Type A accounting for the captive lessor as such; but (unlike today's finance lease rule) no up-front selling profit for the captive's group given a third party RVG.

In reality, as the staff report recognized, captive lessors do not tend to seek third party RVGs. Indeed the manufacturers are often in the business of providing RVGs themselves to third party lessors. So the choice of the two alternatives would make little or no difference in practice. Yet the two Boards disagreed on this. The IASB went for Approach 1 and FASB for Approach 2.

The initial votes on either side were overwhelming. However, when both Boards were asked to vote again as to whether they were prepared to change their first preferences for the sake of convergence, there were only narrow majorities on both sides against doing so.

On the IASB side there was some concern that even a small innovation such as in Approach 2, being consistent with neither current practice nor a previous ED, would strengthen calls for yet another re-exposure.

On the other hand FASB, since they were agreeing to make changes to converge with IFRS, felt that the IASB could perhaps have agreed one small change on their side so as to align with the joint Rev Rec standard.

There was no specific agreement to revisit this issue later in the re-deliberation process, although that could yet change. Otherwise the standard may end up with slightly non-convergent rules in the lessor model.