September 2014: Lease-Accounting Project Moves Forward

Much work remains on the lease accounting project, and we do not anticipate a final standard until early 2015.

The proposal, which has been through two exposure periods, was highly criticized by a variety of constituents in the latest public comment process that ended last fall. In assessing the feedback from their May 2013 Exposure Draft, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) agreed to reexamine most of the significant aspects of the model, and that work began in earnest in March of this year.

So what progress has been made? In March, the Boards tackled the most contentious issues including lessee and lessor classification. While they found some common ground, differences still remain that will need to be ironed out if a converged solution is desired.

FASB Position on Lessee Classification

Consistent with the proposals in the May 2013 Exposure Draft, the FASB continues to favor a dual-model approach for lessee classification under which all leases (other than short-term leases) are on balance sheet, with the expense profile depending on the lease classification.

One notable difference under the FASB's revised dual-model approach is the fact that the criteria used to decide the classification would be those contained in IAS 17. These criteria are very similar to the lease classification tests under today's US GAAP without the bright lines (e.g., 75% of useful life, 90% of fair value). Under the FASB's approach, most of today's capital leases would be Type A leases (accounted for as financing arrangements) and most of today's operating leases would be Type B leases (straight line lease expense profile; this is good news for lessees).

We believe it is safe to assume at this point that the classification approach in the May 2013 Exposure Draft based on the nature of the underlying asset (property or non-property) is on the scrapheap and will not return.

IASB Position on Lessee Classification

In contrast, the IASB has changed its tune on lessee classification and now supports a single-model approach whereby lessees would account for all leases (other than short-term leases) as Type A (or finance) leases which feature a front-loaded expense profile due to the interest component. However, this change needs to be understood in context as the IASB is also proposing a "small ticket" exception for items that are smaller and often leased in high volumes (e.g., computers). Their small-ticket exception would totally scope out these items such that they would be treated as executory arrangements and remain off-balance-sheet.

The FASB expressed concern about such an exemption as it seems to defeat the objective of the proposal for many leases and they are concerned about how "small ticket" may be interpreted in practice (what about copiers? what about cars?). They are also concerned that this would create an exemption for individually small items that could add up to a significant value. The Boards have yet to resolve this issue along with the broader issue of lessee classification and this will likely represent the biggest challenge to reaching a converged solution.

Lessor Classification

As for lessor classification, both Boards agreed to scrap the receivable and residual approach proposed in the May 2013 Exposure Draft. Instead, lessors will look to the IAS 17 model for classification and accounting treatment. While this model is familiar to U.S. companies given its similarity to U.S. GAAP, the absence of bright lines will increase the need to apply judgment particularly when deals are on the fringes of the old bright lines. Overall the decision is viewed as good news because it means lessors can continue to use their current lessor accounting systems.

While the Boards reached agreement on the criteria to be used by a lessor to identify Type A leases, they differed on the way to assess profit recognition for Type A leases that contain manufacturer's/dealer's profit.

The FASB believes that the arrangement would also need to be evaluated under the recently issued revenue standard since this is a revenue event for the lessor.

The IASB, on the other hand, favors retaining the existing guidance for profit recognition. Said differently, the IASB would continue to follow a risk-and-reward model for profit recognition, while the FASB would also require a consideration of transfer of control consistent with the revenue standard that focuses on whether a sale has occurred from the lessee/customer's perspective without considering third-party involvement, such as residual insurance.

Under the FASB's approach, if the lessee does not obtain control of the underlying asset, the lessor would defer the recognition of the selling profit and recognize it over the lease term as part of the constant periodic rate of return (i.e., interest income) recognized on the net investment in the lease.

Lease Term and Short-Term Leases

Other items discussed in March included lease term and short-term leases. In determining the term of a lease, both lessees and lessors should consider economic incentive to exercise renewal or termination options and should consider such options when it is reasonably certain (similar to today's concept of "reasonably assured") that exercise will occur. The Boards agreed to focus on the lease term, as defined, as opposed to the maximum possible term when assessing eligibility for the short-term exception. That is, if there is not economic incentive to exercise renewals, a one-year lease with renewal options would meet the short-term lease exemption, another bit of good news.

Other Areas

Since March, the Boards have met to address various other aspects of the model, including lease modifications, variable lease payments, discount rate, separation of lease and non-lease components, initial direct costs, balance sheet and cash flow presentation, subleases and the definition of a lease.

The issue of the IASB one-lease model vs. the FASB dual-lease model creates major differences in the balance sheet, P&L and cash flow presentation and treatment. The FASB will break out the Type A and B assets and liabilities and consider the Type B liability as a non-debt liability avoiding debt limit covenant concerns for US lessees. The P&L and cash flow treatment of Type B leases will follow current GAAP so that the straight-lined average rent is the reported expense and it is reported as an operating cash outflow. Some other minor differences remain in some of these areas but they appear to be things that can be resolved.

The variable lease payment debate centers on the subsequent measurement by lessees. The IASB believes lessees should remeasure the lease obligation when there is a change in the contractual cash flows as a result of index or rate changes, while the FASB is comfortable with remeasurement only when the lease liability is reassessed for other reasons within the control of the lessee (e.g., a lease modification or lessee action that causes lease term reassessment).

With regard to the definition of a lease, the Boards revisited substitution rights and raised the bar on what constitutes a substantive substitution right. In the Boards' view, such rights need to be practical, which includes a condition that the lessor must economically benefit from the substitution.

The Boards also decided that initial direct costs will include only incremental costs that the entity would not have incurred if the lease had not been obtained. Lessors' allocated internal costs would no longer be eligible for capitalization under this definition.

With regard to subleases, the Boards currently disagree on whether to focus on the underlying asset or the remaining right-of-use asset under the head lease when assessing sublease classification.

A Look Ahead

It is expected that the Boards will address sale-leasebacks, disclosure and transition and effective dates in future meetings. Given the implications of repurchase options in the new revenue standard (they preclude sale since they allow the seller to retain control), many equipment lessors are keenly interested in the transition requirements for sale-leasebacks. The Boards will also discuss how to assess the transfer of control when the seller retains physical possession of the sold property under a leaseback.

We also expect leases of "small" assets to receive additional deliberation. In addition, the FASB also has a few areas that they will deliberate independently including leveraged lease accounting and private company and not-for-profit issues.

At this point, despite the overhaul of several areas, we do not expect another public exposure of the proposal. The Boards believe that they understand the perspectives of users and preparers alike based on the significant volume of comment letters received to date and the other forms of public outreach performed. However, unsolicited comment letters are always an option if you have concerns about the direction of the project.

As mentioned above, we would be surprised to see a final standard before 2015. Based on this expectation, an effective date any earlier than 2018 would seem unrealistic. Stay tuned!

Update: New Lease Accounting Rules Expected in Early 2015

Staff at the SEC's Office of Chief Accountant, meeting June 11 with representatives of ELFA member organizations, re-affirmed the intention of the FASB and IASB to issue new lease accounting rules in early 2015. As part of its Capitol Connections program, which enables ELFA members to "speak with one voice" to members of Congress, their staff and key agency officials on critical legislative and regulatory matters, executives representing 12 ELFA member companies met with the staff of the SEC Chief Accountant's Office to discuss latest developments and provide their insight on the Leases project. The takeaway from the meeting was that, despite disagreements between the two Boards, the process of re-writing lease accounting rules continues to move forward. As explained in the accompanying article, the FASB is siding with the industry's and association's position on critical recognition and financial reporting matters, and it remains to be seen how and in what form the final rules account for these discrepancies. The ELFA continues to closely monitor the project and provide useful information and input to the Boards as they seek to finalize the new rules.

Bill Bosco is the Principal of Leasing 101, a member of the Equipment Leading and Finance Association's Accounting Committee since 1988, and a member of the FASB/IASB Leases Project working group. James Barker is a partner in Deloitte's national office where he specializes in financial instruments and leases. He has served on the ELFA Financial Accounting Committee since 2011. More information about lease-accounting rules and updates are available here.