Responses to the exposure draft

An analysis of responses to the FASB/IASB proposals to change lease accounting

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An Asset Finance International White Paper
published in association with **International Decision Systems**

V5.1 - December 3, 2010

Acknowledgements

The publisher would like to thank the following for their assistance in the preparation of this document

Mr Mark Venus, Projects Director, BNP Paribas and
Chair of Leaseurope's Accounting & Taxation Committee

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This document will be regularly updated as new responses are received by FASB/ IASB. Updated copies are available from:

http://www.idsgrp.com/
http://www.assetfinanceinternational.com

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Foreword from William G Sutton, CAE, President, ELFA

The Equipment Leasing and Finance Association (ELFA) is the trade association representing over 500 financial services companies and manufacturers in the $521 billion U.S. equipment finance sector. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation in the U.S. and abroad. Overall, business investment in equipment and software accounts for 8.0 percent of the GDP; the commercial equipment finance sector contributes about 4.5 percent to the GDP.

Equipment leases finance all types of equipment to all types of companies but most importantly to small and medium-sized enterprises (SME). The SME sector is cited as the largest potential source of job growth needed to reinvigorate the economy worldwide. Access to capital and efficient use of equipment are the primary drivers for lease financing and not financially engineering off balance sheet transactions. The proposed Leases standard was intended to capitalize lessee operating lease obligations to improve transparency but the Exposure Draft goes much further than the stated objective. The proposal capitalizes payments that are estimates (not true liabilities), accelerates costs for lessees, creates a huge compliance burden for lessees and lessors, and changes lessor accounting in ways that will increase lease rates to maintain shareholder return targets. These factors result from choices made by the IASB and FASB beyond what is required to meet the stated objective.

Most comment letter respondents thus far do not agree with the proposed decisions made by the Boards. These far-reaching changes create a permanent charge to earnings and capital and will alter behavior of lessees and lenders/investors to such an extent that they may well have an extraordinary negative impact on the economy.

Accounting is not an exact science and we hope the Boards seriously examine the views and alternatives suggested by the comment letters. Many alternatives are based on sound reasoning and do not conflict with the objective of capitalizing true liabilities created by operating leases.

Your readers are stakeholders in this new accounting standard as lessors, lessees and/or users of financial statements – many ELFA members fall into all three categories. The negative aspects of the proposed rules can be changed as the FASB/IASB are requesting comment letters as part of their normal due diligence process. This process is not over--but time is running short! The views of stakeholders matter. We urge you to exercise your influence by writing a comment letter on the issues contained in the Exposure Draft.

For more information or to learn more about this project, contact Ralph Petta rpetta@elfaonline.org, who is coordinating the ELFA's activities in this matter. Also visit the Lease Accounting Project page on the ELFA website at www.elfaonline.org/ind/topics/Acctg/.

William G. Sutton, CAE
President, ELFA

Foreword from Mark Venus, Chair of Accounting and Taxation Committee, Leaseurope; Projects Director, Group Development Finance, BNP Paribas

The Boards have set a deadline of 15 December 2010 for responses to their Exposure Draft proposals. From then the Boards will re-deliberate the proposals and plan to issue the new accounting standard in Q2 2011.

When lessors and lessees look at the thinking that underlies the Exposure Draft then the Boards' proposals are seen as being far from as consistent and coherent as they would have us believe. Many elements of the propos-als fail to meet the Boards' own objectives, to respect the Boards' conceptual framework, and to respect the reality of the leasing market.

The stated aim of the Boards was to propose a unique accounting model for all leases. However, while I believe this is achievable, it creates the need to carefully define appropriate frontiers at each end of the lease spectrum - and the Boards have failed to adequately meet this requirement. The practical implications of the reform pro-posed by the Exposure Draft are major, and many who may have sympathy with the boards' aims may still feel that the proposals are insufficiently pragmatic and proportionate. The boards are ready to listen to comments and criticisms, and the Exposure draft should not be seen as as a done deal.

The comment period to the Exposure Draft is an important opportunity for those with concerns on the proposals to react. It should ensure that the lessor accounting proposals are significantly improved. It should also ensure that both lessor and lessee accounting are truly simplified and that the overall model is consistent.

Leaseurope is committed to assisting the IASB in achieving its goal of improving financial reporting for leases but several overarching issues will have to be resolved before this can be considered to be the case.

I hope that Asset Finance International's publishing of lessors' and lessees' concerns will inspire interested par-ties to respond to the Exposure Draft within the ever-shortening timescale.

Mark Venus
Chair of Accounting and Taxation Committee
Leaseurope

NB Additions to text since the previous white paper are marked in blue

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Industry comments up to December 3, 2010

The exposure draft(ED) was released in August 2010 with a response deadline of December 15. As of December 3 a total of 76 responses had been posted. These responses are likely to be a relatively small proportion of those eventually returned, and their pattern may not be fully representative of the final position. Larger organizations tend to take advantage of most of the permitted response deadline.

However, some trends are becoming apparent. In particular:

- The proposal for lessees to capitalize operating leases enjoys wide, though far from unanimous, support.
- There is overwhelming opposition among early respondents to the ED proposals on lease continuation options.
- On the lessor accounting side there is very strong opposition to the ED's “hybrid” proposal and a clear majority against the “performance obligation” variant.

The ED will apply to both real estate and equipment leasing. In this *Asset Finance International* update the analysis is concentrated on the issues most pertinent to equipment leasing. Some of the comments quoted below are in themselves focused on the real estate sector. However, they have been included, since the accounting issues to which these relate will also be important for equipment leasing.

The check list below summarizes the pattern of early response, broken down by type of respondent and by the major emerging issues within the ED.

Some respondents have commented in a personal capacity and have not disclosed their occupations. These are included within “market analysts and others” in the check list. Those listed under “lessor interests” include lease brokers and advisers; and those capital equipment suppliers who appear to be focusing their comments on leases of their products, rather than commenting principally as lessees of other asset types.

The pattern of responses to December 3, 2010

		Lessor interests	Lessees	Auditing accountants	Analysts & others	Public bodies
Lessee Capitalization	Support	**7**	**4**	**9**	**8**	**3**
	Conditional support	**4**	**7**	**4**	**2**	0
	Opposition	7	**3**	**5**	0	**2**
Lessee Amortization	Support	1	2	**7**	**5**	**2**
	Opposition	**7**	**4**	**3**	**3**	0
Preferred lessor accounting model	Hybrid (as per ED)	0	0	**3**	0	**1**
	Performance obligation (PO)	0	0	**3**	**3**	0
	De-recognition (DR)	**4**	0	**6**	**4**	3
	Current rules	**5**	0	**3**	0	1
Preferred option for continuation rentals	Support as per ED	0	1	2	2	0
	Support on different basis	0	0	1	**2**	**1**
	Opposition	**16**	**10**	**7**	6	**4**

Lessee capitalization

The ED proposes that all lease agreements should be capitalized on lessees' balance sheet as "right of use" (ROU) assets with corresponding financial liabilities. This would replace the present rules where only finance leases or capital leases" as they are known in the USA – (i.e. those where the lessee assumes substantially all the "risks and rewards of ownership") are capitalized; and operating leases (i.e. all other leases) are off-balance-sheet.

Supporters

PricewaterhouseCoopers (PwC) supports capitalization, and comments: "We support the Boards' analysis that rights and obligations arising in a simple lease meet the definition of assets and liabilities ... As a result, for lessees we believe the ROU model provides a better underpinning for a new standard than the current model."

US industrial company lessee Lubrizol also supports the proposal, commenting: "We believe that the [proposed] new accounting model improves the reporting of lease agreements and reduces the ability of entities to structure economically similar agreements to gain different accounting treatment."

The British Helicoptor Association, representing operators of these aircraft, is among lessees supporting the change. It says: "... There should be an end to the often minimal distinction between finance and operating leases where the difference of 1% in the degree of commitment could determine whether or not the whole cost of an asset appeared on a lessee's balance sheet....

" [Our] members ... who give financial covenants to lenders have tended to find that lenders adjust total debt to include the [discounted present value (PV)] of committed rentals streams in any event. The methodology used for many years to establish 'adjusted debt' by the leading rating agency, Standard and Poors ... is remarkably similar to that proposed in the ED. In this respect, the main proposal ... is merely catching up with what lenders, rating agencies and creditors have been doing for a generation."

Computer Financial Systems Inc (CFS), a US provider of lease accounting services and software, comments: "... Operating lease accounting understates the liabilities of a [lessee], and capitalization provides a needed truer picture. Current disclosure [in footnotes] is insufficient to provide this."

The Australian Joint Accounting Bodies (JABs), representing the country's audit profession, agrees. It comments: "...We believe that it is control of the right to use an asset that should determine recognition of an asset by the lessee ... from the commencement of the lease."

Though it records a dissenting view among some of its members, the Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC), an Australian body representing Federal and State public finance officials, states a majority view in favour of capitalization. It says: "The present [lease accounting] model, based on a somewhat arbitrary distinction between finance and operating leases, is flawed, is open to abuse, and fails to recognize the assets and liabilities arising under operating leases."

The Australasian Council of Auditors General (ACAG), a similar continental association of official public finance auditors, comments: "The proposed model ... will improve financial reporting due to the removal of the distinction between operating and finance leases, thus ensuring the recognition of assets and liabilities for all leases."

Private respondent Linus Low is another supporter: "I think the recognition of a ROU asset and a liability in the books of the lessee provides a more faithful representation of the economic substance of a lease arrangement than the existing finance/ operating lease accounting model...."

"The abolition of the distinction between finance and operating leases will significantly eliminate the problem of 'off-balance-sheet financing', and thus improve the financial reporting of lease arrangements, making it more transparent for investors and other financial statement users."

Auditor Rajnish Ramchurun suggests that lessee capitalization "will make leases ... consistently treated in financial statements and allow comparability for end users."

Among more conditional supporters of capitalization is the German institute of public auditors IDW. It expresses concerns as to whether leases under the ROU model will end up being accounted for consistently with comparable transactions of other types It says: "Before [such] a

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considerable change in lease accounting is implemented, the accounting for executory contracts needs to be deliberated in general as part of the Conceptual Framework project.

"There is a danger that contracts that exhibit similar characteristics may not be accounted for consistently... If the ROU model is implemented for lease contracts whilst other executory contracts with similar characteristics (especially service contracts) remain off-balance-sheet, the proposals offer structuring opportunities...

"Provided that the outstanding conceptual deliberations support the Boards' assumption that a lease is not an executory contract, we agree [with lessee capitalization]."

Opponents

The Swedish Financial Reporting Board (SFRB), which oversees the implementation of international financial reporting standards (IFRS) rules in Sweden, is the most prominent opponent of the ED proposals to date. Its opposition is based mainly on perceived inconsistency as between the lessee and lessor accounting rules in the ED.

It says: "We consider that the proposed standard should not be introduced. ... The proposed two-model approach to lessor accounting in the ED is to a great extent similar to the present approach under IAS 17. On the other hand the ED requires that for lessees all leases should be brought on to the balance sheet. This is not logical and is itself a strong argument ... that IAS 17 should be retained."

The Dutch Accounting Standards Board, which oversees the generally accepted accounting practice (GAAP) for unlisted companies in the Netherlands, also takes issue with the proposals. It suggests that they are inconsistent with both the current IFRS version, and the draft IASB/ FASB convergence version, of the overall Conceptual Framework for accounting standards.

DASB states: "We believe that the concept of the ROU model is not well founded. We see a conflict between the recognition criteria of the ROU asset and the related lease liability, and the [respective] definitions of an asset and ... a liability in the current and the new Framework."

Cathay Pacific Airways is among major lessees to have voiced opposition. It says: "By accounting for all lease arrangements in the same way, the financial statements will less accurately reflect how management manages a business. One of the key considerations of asset management ... is to manage the exposure to residual value (RV) risk.

"In the context of the airline industry [the ED would] require airlines to recognise existing aircraft operating leases on the balance sheet as assets on the same basis as finance leases. However, management does not necessarily enter into operating leases as a means of financing but as a means of managing exposure to RV and to befit from the flexibility that these ... leases provide ...

"The accounting distinction [between finance and] operating leases permits reflection of the commercial reality of management decision making. By elimination the operating lease treatment ... this important distinction will be lost.

"...Users of financial statements are likely to interpret recognition of an asset on the balance sheet as being a reflection of the airline's exposure to RV risk on these assets ... [which] for operating leases in practice continues to reside with the lessor ... The proposed accounting treatment is at odds with both commercial reality and the legal/ contractual position."

US equipment lessor Somerset Capital Group suggests that minor alterations to existing standards would deal with any anomalies in lease classification. It says: "An operating lease is a right to temporarily use an asset owned by another party ... That is very different from a lease which is purely a financing where the lessee will enjoy all or most of the benefits of ownership ....

"Naturally there are leases that are not instalment sales .or financings but under today's standards are treated as [finance leases] since they meet one of the current bright line tests in ... FASB 13 [current US leasing standard]. While those bright line tests may need to be revisited and updated ... a complete overhaul of the current standard still does not seem to be the most appropriate approach ...

"If leases should be viewed as creating ROU assets, why would not other period expenses be treated similarly? Are we opening the door with this new standard to the capitalization of payroll, utility contracts, professional contracts etc?

US accountancy firm Cover & Rossiter comments: "The ED draws no distinction between small office copier, vehicle and postal machine leases that exist at nearly all entities and a very small number of massively complex leasing structures that have come into existence with a specific accounting treatment in mind."

"In attempting to cure the perceived inconsistency of treatment with a very small percentage of actual

leases, the Boards will impose substantial conversion and ongoing costs on all entities."

The firm suggests that account users can glean the necessary information on major leasing commitments from the disclosures already required in lessees' accounts: "...The current lease accounting rules ... are not perfect but they do ... provide a framework around a difficult topic...."

"In the overall small percentage of entities where there are large and complex leasing strategies being employed, financial statements are rarely taken at face value by those relying on them. Where those financial statements are being analysed, ... generally the wherewithal exists to employ individuals with the relevant expertise ... [to cut] through the accounting treatment to the substance of significant leasing transactions."

US accountant Alicia Boyd is another outright opponent. She comments: "In many instances, operating leases are utilized for vehicles, copiers, and other equipment. Reporting these leases on the balance sheet as an asset provides little, if any, added information to the reader of the financial statements. Further, the exclusion of these equipment leases would not sway the reader of the financial statements [in investment or lending decisions]."

"In fact, including operating leases on the balance sheet would seem to be deceptive to the investor or lender, as it gives the appearance that the lessee is utilizing an asset for most of the asset's useful life, when in fact, this is untrue."

US independent equipment lessor Elex Group Inc stresses the compliance costs for lessees: "There is no distinction made between the small equipment leases that make up the majority of lease transactions with [small and medium sized enterprises (SMEs)] and the more extremely complex operating leases that were structured [for] the sole purpose of off-balance-sheet treatment ...

"In trying to combat the presumption of inconsistent treatment in a very small percentage of leases, the ED imposes substantial costs for all entities... ,The [capitalization] requirement ... provides no greater assistance for a reader of ... financial statements in determining [the lessee's] obligations and financial strengths than the current footnote requirements.

"Under the current ... rules any reader of a financial statement will include operating lease liabilities in their calculations and knows where to readily find them."

Steve Harding, chief financial officer (CFO) of US real estate lessor Transwestern Commercial Services, comments: "Current treatment and disclosure rules are adequate. Fundamentally I understand what the Boards are trying to achieve, but I am concerned about the complexity and subjectivity of the new proposed rules...."

"The impact that this will have on loan covenants will be profound and costly for the tenant to put in place....The costs are simply too great and the benefits too little to force tenants ... to apply this new accounting ... In the current state of our global economy, tenants cannot afford that additional burden. Now simply is not the time for this change."

Among lessee respondents, opposition is expressed by the Devereux Foundation, a US not-for-profit provider of special needs health and education services. "The recording of an asset and liability on the lessee's books unnecessarily grosses up the balance sheet and provides no greater assistance to the financial statement reader than comparable disclosures in the footnotes would do. In fact ... it will draw unnecessary attention to the lease-related captions in the balance sheet and ... potentially divert the reader's attention from other important items."

Loftness, a US capital equipment manufacturer, comments that "Operating leases provide a means to acquire needed new equipment, machinery or vehicles ... where a company's balance sheet is not strong enough to add debt to the liabilities side."...Banks and other financing institutions will inevitably include the ... operating lease liability in their calculations of ... loan repayment capacity while not [giving credit for the value of] the operating lease asset due to it not being available to them as collateral or equity......For growth mode ... or start-up businesses, this is potentially a growth or survival killer."

Small and non-core assets

Some conditional supporters of lessee capitalization nevertheless suggest exceptions for certain types of lease contract. Some outright opponents also call for exceptions if the Boards proceed with the main proposal.

Tata Steel Europe, a major manufacturing sector lessee, comments: "We agree with the proposed lessee accounting model. The recognition of a ROU asset reflects the fundamentals of the arrangement entered into ...

"However, ... we are concerned that the

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application of these requirements to low value assets ... will create an unnecessary and significant burden on preparers of accounts that is not justified on cost/ benefit grounds. ”

Greg Klein, CFO of US industrial company Inland Truck Rentals, commenting in a personal capacity, suggests an exemption for relatively small equipment leases. He comments: “...If a company leases its copiers for three years, there has to be an exclusion that allows leasing obligations that fall under some materiality threshold to be treated as operating leases [i.e. off-balance-sheet].

“Requiring these immaterial assets to be handled as an asset and liability would be overly cumbersome and not meaningful to the reader.”

David Mirsky, co-founder of US equipment lessor Pacific Rim Capital Inc, comments on the same lines: “My average lessee is a Fortune 200 company who lease $5m of equipment from us annually. Many of these lessees sign hundreds of schedules with us. [In the USA] there are millions of separate transactions done by thousands of companies.”

“The burden of [compliance] ... will be very large and expensive, in many cases without adding transparency to the financial statements of such giant companies. Therefore, I believe that there should be some size or materiality consideration for such new rules.”

Also responding on these lines is US real estate lessor Jackson Cross: “[We recommend] some materiality standard, either for individual leases or for the cumulative value. While compliance considerations may not be grounds for altering standards, common sense cost/ benefit analysis suggests that tracking, adjusting and reporting on every piece of leased equipment, property or machinery would warrant a materiality threshold.”

“In particular large, multi-location [lessee] operations, that currently delegate contracting responsibilities throughout the organization, will incur huge expenses to create the necessary tracking processes.”

Cathay Pacific says: “ ... Non-core or low value leases should be excluded from the scope since the information will be of little value to users of the financial statements but requires substantial efforts to prepare. Typical of any airline company, we have thousands of such [non-aircraft] contracts...

“In the case of short term office leases, we would potentially report many properties in the financial statement as leased assets when these are not 'assets' in substance. This change of treatment ... would be bemusing to many readers.”

All accounting standards are in fact subject to an overriding materiality qualification, and this would apply to the proposed new leasing rules. However, this is generally interpreted as a very low threshold, and would not meet the concerns of some critics of the leasing ED’s impact on smaller assets..

Small and medium sized enterprizes (SME’s)

Some respondents suggest exempting smaller companies permanently from the capitalization requirement. Among jurisdictions accepting IFRS, there will in any case be at least a further delay before SMEs become subject to the leasing standard.

For the IASB maintains a separate general accounting standard for SMEs. which does not immediately incorporate features of other newly adopted standards. It is reviewed periodically to determine whether requirements of recently adopted general standards should be added to it. In addition some countries, especially in Europe, apply IFRS only to listed companies.

The European Federation of Accountants and Auditors for SMEs (EFAA) has called for a permanent exclusion of SMEs. It says: “We fully support the focus of this ED ... [but it] serves to make lease accounting more complex. Our support is therefore in principle for the changes to be made to IFRS for listed companies where accounting misuse under the existing [leasing] standard may well be more prevalent ...”

“We do not believe that the changes required under the ED should be incorporated into IFRS for SMEs ...”

“The quality of information presented in the financial statements in respect of operating leases is the fundamental issue. Many users of financial statements use the [required operating lease disclosures] to project future cash flows. They are less concerned with whose balance sheet the asset and liability sits on as long as they can estimate the cash flow impact on the business that they are assessing.”

“This is particularly relevant to SMEs. Accounting for the lease of the office photocopier under the ED adds little to the veracity of SME accounts.”

The Office of Advocacy, a US public body established within the Small Business Administration (SBA) to represent SME interests to Federal agencies and the Congress, makes very similar points. It says: “As an example of the wide

ranging scope of the proposed standard, even a small business that leased a $1,000 photocopy machine for a fixed period of two years would be required to change its financial statement and report the photocopier as an asset ...

"[We recommend] ... alternatives that would minimize the burden of the proposed standard on small businesses engaged in shorter term, less costly lease transactions."

"Specifically [we] recommend ... a de minimis exception that would exempt lease transactions of less than $250,000 from the proposed standard."

"[This] would exclude small businesses with 'small ticket' leases from administering the costly and complicated proposed standard but would still accomplish [the Boards'] objective by requiring significant lease transactions ... to comply with the new standard."

The Motor Trade Association of New Zealand (MTA NZ) says: "As a minimum, serious consideration should be given to the standard applying only to assets over a certain value e.g. $1m and to certain organisations [e.g. public companies]."

US accountant Jeffrey B Kraut suggests that the Boards should consider applying capitalization to public company lessees only – which would represent a small minority of all lessee businesses.

Violation of covenants

Like Harding (see above), some of both the conditional supporters and outright opponents of capitalization point out that it will put some lessees in technical violation of loan covenants restricting overall leverage. For example, US accountant David L Wagner comments: "I partly agree with the Boards' assessment of costs and benefit ... I believe, however, that there is one potential cost that has been left out.

"What of the effect of recording significant amounts of debt on entities' balance sheets? Many of these entities will have debt covenants that include leverage and debt-to-equity provisions. The proposed statement will put hundreds (or more) of these entities in violation of their covenants ..."

"It is far from sure that a violation will be forgiven in today's climate, particularly if the debtor was already only marginally meeting the covenants and the bank is more interested in protecting its recovery options than in making allowances for the effects of new accounting standards that have overnight turned the entity into a violator."

"Thus the Boards put at risk an unknown number of jobs at a time when the global economy is struggling ... Is it worth the risk?"

Kraut makes a similar point: "Mathematically a company may now be in violation of debt agreements due to a change in accounting principles, but with no change in ... true financial conditions. Renegotiating covenants to exclude [this] effect may be difficult..."

Mirsky is also concerned about this aspect: "Loan covenants will be violated, and unless they are changed, which will not happen rapidly for [SMEs] during these tight credit conditions, corporations will not be able to borrow as much money."

In similar vein, Cathay Pacific comments: "The effect on existing covenants may lead [banks] to restrict lending to some companies. To avoid such impact, the banking industry (like the analysts) would have to look behind the balance sheet in order to strip out the impact of such increased liabilities on company gearing."

MTA NZ says: "... Some banks already exclude intangible assets from their bank covenants as they are 'not real' assets and also have values based on judgement. Debt ratios and other liability related covenant metrics, however, could be impacted [by capitalization] without the requisite understanding by the funders."

Some respondents, particularly in the US real estate sector, suggest that in current conditions bank lenders may purposely take undue advantage of the debt covenant impact of lease capitalization. A major lessee company, US retail group Express, says: "By significantly altering the amounts included in the covenant calculations, [the result of lease capitalization is] that a number of debt agreements will need to be renegotiated, which could lead to additional costs for debtors and windfalls for lenders, even though the underlying fundamentals have not changed ... The [lending] banks should have been aware of the rent obligations [from] footnotes to the financial statements [under existing standards]".

The US National Association of Realtors (NAR) expresses similar fears: "... The proposed guidance gives lenders the opportunity to restrict credit terms or the availability of credit ... or to negotiate monetary penalties for 'paper' violations of debt covenants that result simply from the application of the new guidance."

"Lenders could potentially even take the opportunity to declare an event of default."

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Costs versus benefits

US accountancy firm Milbern Ray suggests an exemption for SME lessees. It points out that for many such firms, the accounting adjustments required for presently off-balance-sheet operating leases could add significantly to their external audit costs.

Largely because of its concerns over the lease continuation proposals (see below), Swiss-based construction materials producer Holcim calls for more cost/ benefit analysis of the main lessee accounting proposals. It says: “We do not believe that the proposals are effective in addressing the concerns about the complexity of lease accounting and comparability of information. Furthermore, we are not convinced that the proposals result in information that is relevant to users of financial statements.”

“Since leases are so widespread, we believe that the IASB should further develop and field-test its thinking, and subsequently:

- better define what information users need;
- clearly distinguish between what should be recognized in the financial statements and what should be disclosed ...; and
- make a thorough assessment of the costs.

“We acknowledge that our recommendations may not be compatible with the June 2011 deadline that the Board has set for itself in this project. However, we believe that supplementary time required to make the final standard robust and worthwhile is a matter of months and not years.”

Somerset Capital likewise raises the cost/ benefit aspect: “Without a significant benefit from ... the new lease accounting standards one must seriously consider the wisdom behind adopting such a sweeping change, especially in these difficult economic times when reporting entities and consumers can ill afford the direct and indirect costs of such changes.”

HoTARAC calls for a longer than usual implementation period for the new standard, as a partial solution to the compliance cost issues. It says: “Many lessees will find [the capitalization model] very burdensome ... [We] therefore urge the Boards to consider whether any ... relief can be given to ease the burden of making the proposed changes [including] a substantial period for implementation ...”

Other lessee accounting issues

Amortization and expense profile

The Boards propose front-loading of lease expense recognition by lessees over the lease term, by combining straight line amortization (i.e. depreciation) with a front-loaded schedule of interest expense.

Several respondents are critical of this proposal. Somerset Capital comments: “Under current ... standards lessees recognize their expenses related to operating leases on a straight line basis. This is logical and sensible given that the customer's use of the asset, and benefits derived therefrom, tend to be spread evenly over the term of the lease.

“Under the proposed standards a lessee's expense ... would be heavily weighted towards the early stages of a lease as a result of the use of the [proposed method of] amortizing the interest expense in the capitalized lease obligation. This mismatch does not reflect the economics of a lease transaction.”

Cathay Pacific comments: “[We have] concerns about ... the mismatch between the recognition of the 'financing' expense and the economic benefits realised from the lease. Under the proposed model the asset is typically amortized on a straight line basis while the obligation is accounted for using the effective yield method. Together, this will lead to higher expenses during the early part of the lease term ... This may deviate from the timing of recognition of the economic benefits. For an aircraft operating lease ... the economic benefits of the lease are not materially [variable] over the lease term. However, under the [ED] the airline will record a higher financing expense at the early part of the lease [compared with] the latter part.”

Kindred Healthcare, a major US provider of commercial medical treatment, has similar concerns. It says: “... The widening disparity between reported operating results and cash flows that would arise under the new lease accounting rules [is] of particular importance [to us]. “

“For the three years ended December 31 2009, the difference between rent expense computed under GAAP and cash rents was [consistently small]. Under the proposed guidance, we estimate that this deviation will grow dramatically in varying directions ...”

“Although it is not clear how financial statement users will react ..., additional guidance may be necessary from the Boards to assist preparers and

users [of accounts] alike in communicating and reconciling the income statement and cash flow differences associated with leases."

"In our view, if the proposed lease accounting changes are adopted, it is likely that financial statement users in our industry, in order to achieve comparability, will choose ... alternative non-GAAP approaches ... to evaluate the company's operating performance ... "

"[This is] generally not desirable and should be discouraged rather than encouraged by new accounting pronouncements."

Dacourt Group, a US real estate lease broker and property manager, while supporting the principle of lessee capitalization, opposes the expense recognition proposal. It suggests instead a "mortgage annuity" type of approach where the front-loaded interest would be balanced by a back-ended amortization schedule to produce a level profile of overall expense.

Dacourt comments: "With the ... proposed amortization method, when renewal options are initially predicted and the prediction is not accurate, lessees will then have to recognize a large gain when the [contract] is abandoned. It seems illogical to adopt a standard that has the potential to produce such distorted outcomes."

"The Boards concluded that straight-line amortization is appropriate because it is consistent with similar financial reporting for other assets. We recognize the importance of consistency in financial reporting, but the newly created ROU lease asset is different [from] many other assets. We believe it is appropriate to use an amortization method that ... accurately reflects the transaction's economics even if the ... method differs from ones used for other assets."

- Leases under water

Bill Bosco of US lease advisory group Leasing 101 sums up the problem with the Boards' proposal and suggests a solution within the framework of the ROU approach.: "Using straight line amortization of the ROU asset makes the lease contract appear to be 'under water' immediately, since the book value of the asset amortizes more quickly that the liability."

As the alternative, Bosco suggests: "Amortize the ROU asset at the same rate as the debt amortization. Accrue rent payable at the average of cash paid for rent. Link the lease costs on the profit and loss statement (P&L), and label the cost as rent expense. This approach more faithfully presents the periodic costs for the use of the asset."

"In my opinion readers of financials expect to see rent expense in the P&L of lessees as an operating expense and expect the reported cost pattern to be straight-line. The reported cost of using a leased asset should not be different in the first month of a lease versus the last month of a lease as long as the asset is able to produce the same benefits."

Mirsky comments on the same lines: "The [amortization] proposals will result in the largest charge to earnings in the first year of the lease with the charge decreasing over time. This does not reflect the parties' intent, nor does it match the cash flows of the lease, where the payments are level throughout the term ... We believe that it will sow confusion and simply not tell the story of the transaction that is occurring."

Elex comments: "The [ED proposal] creates front end loaded expenses on the part of a lessee and makes it more difficult for a reader of financial statements to understand the true cash obligations of the lessee ... Readers of financial statements are more concerned with the cash obligations and the cash flow of a company, not the amortization of the ROU of an asset."

"The front loaded expenses will [both] make it more difficult for a user [of accounts] to understand the true cash obligations of a company and ... make [leasing] less attractive as a financing option on the part of a lessee."

Australian based Ardent Leisure Group sums up the problem from its standpoint as a lessee: "For the majority of our businesses we would expect revenue and profits to increase over time and currently most of our rental agreements include either a fixed rental or [consumer price index (CPI)] increase each year and so match this increase."

"Under the proposed new standard, the P&L impact will not reflect the outflows of the business and will front load expenses. This does not fairly match the revenues generated by the business over the lease [period] with the lease expense."

Like Bosco, private respondent Chris Barnard makes a case for a linked approach to the amortization of the asset and liability, so as to avoid the deferral of net income recognition for lessees under the ED proposal. He says: "I ... agree that a lessee should amortize a ROU asset and recognise a liability to make lease payments. However, although the two items are OK in isolation, when taken together they lead to an overstatement of lease

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expenses early on, and an understatement later on,

"This can [become] very significant as the lease term increases, [and/or] as the [implicit] interest rate increases."

"I would strongly recommend ... a consistent amortization method on the ROU asset and and the lease liability, in order to mitigate this distortion in lease expensing, and hence in profit reporting."

Similarly, Canadian chartered accountant David Nayer comments: "[I suggest that] both the ROU asset and the associated liability be expensed in the income statement in the same fashion, thus assuring that the assets and the corresponding liability [throughout the lease period] ... will net to zero, and will not inflate the balance sheet.

"The associated expense in reducing the liability should be amortization expense and not interest ... [Account] users do not like 'fictitious' interest caused by accounting entries as it skews the ability to calculate the company's weighted average cost of capital."

CFS takes a less committed view, and draws attention to one perceived flaw of the linked approach. It says: "[The ED approach] is consistent with purchase accounting ... We appreciate, though, that the switch from rent expense, which is generally level over the life of a lease, to amortization and interest expenses, the latter of which is front loaded, can produce a mismatch between expenses and associated income (which would not be expected in most cases to decline over time) ...

"We would not be averse to [the linked approach alternative] ... This would, however, raise potential complications in cases of negative principal amortization, which we believe should be explicitly addressed if this route is followed."

Tata Steel Europe makes a more narrowly focused criticism of these ED proposals. It says: "We believe that describing the decrease [i.e. writing down] of the ROU asset as a rental expense in the income statement ... as opposed to amortisation ... is more appropriate on the basis that the decrease represents the costs for the use of the leased item ..."

Some US respondents draw attention to a discrepancy with US tax rules resulting from front-loading expense for reporting purposes. Somerset Capital comments: "Since the tax treatment of an operating lease would, at least for now, remain [unchanged], the proposed changes in lease accounting standards would result in a timing difference between accounting and tax basis expense recognition, thus producing deferred tax items [in the accounts]. Naturally this adds to the accounting burdens."

Similarly, Office of Advocacy notes: "Under the ED, all [US] leases would have book/ tax timing differences requiring complex deferred tax accounting; currently, most small business lessees do not contend with [this factor] because the current lease accounting rules are consistent with [US lessee tax expense] rules."

The global accounting standard setters cannot address tax accounting rules. These are of course variable in individual countries. Depending on the reactions of tax authorities, in some jurisdictions the front loading of lessees' expense for accounting purposes could result in bringing forward the tax expense for rentals. In the US this seems unlikely.

- Supporters

Among those supporting the ED amortization proposals, the Australian JABs comment: "[The ED] is consistent with the general rules for accounting for intangible assets with a definite life and property, plant equipment assets purchased on deferred terms by instalment."

Lubrizol also supports the Boards' proposals. It comments: "While the proposed expense pattern is a departure from the historical requirements of straight line expense recognition, we believe that this is the only approach that would fit with the new accounting framework."

- EBITDA impact

US leasing consultancy Mindthegaap is concerned that the proposed lessee amortization rules will distort the use of the "earnings before interest, tax and amortization" (EBITDA) measure of corporate performance.. Since it generally supports the ROU model, it proposes additional disclosure rules beyond those proposed in the ED to address this.

It comments: "As compared with [exiting standards] a number of lessees will report increased EBITDA, because the rental expenses previously associated with operating leases will instead be reported as amortization and interest expenses. As EBITDA is an important performance measure for financial statement users, we ask the Board[s] to ensure that investors and creditors are appropriately informed – and approving of – the impact of the ED on reported EBITDA."

"If the [amortization/ interest expense split] is

ultimately adopted, we strongly recommend that lessees should also be required to present in the footnotes a sum total of amortization and interest expenses arising from leases. Such disclosure will provide useful information to investors about the total costs of [leases].”

- Impact on voluntary organizations
Devereux Foundation is critical of the Boards' expense profile proposals. It fears that for an organization of its type the pattern of its governmental funding reimbursements could be affected.

Other US respondents make the same point. Bosco comments: “Replacing rent expense with amortization and imputed interest expense will create issues with cost reimbursement in existing contracts and with existing government regulations. As an example, in the US Medicare will reimburse hospitals for non-medical equipment rent expense but there is no reimbursement for amortization and imputed interest expense.”

Alicia Boyd, who is based in Indiana, suggests that in that State there could be significant effects on Medicaid reimbursements to not-for-profit healthcare providers.

Banks as lessees
PwC draws attention to a particular problem from lessee capitalization for companies subject to capital adequacy regulation, especially banks. This arises from their positions as lessees of significant numbers of buildings in their branch networks. PwC comments:“The new model increases balance sheet assets [for lessees], with the likelihood that the regulators will require more capital to be set aside. Banks are particularly concerned that if the assets are treated literally as 'intangible' assets, regulators might treat them in a similar way to other intangibles as a deduction of capital.”

“This would have severe repercussions for the banking sector. Alternatively, ... the regulators might treat [the assets like] other tangible fixed assets, with a risk weighting of 100%, which would still have an impact on banks' capital requirements, but not to the same degree.”
Office of Advocacy suggests that in the US smaller regional and local banks will be among those most adversely affected. It says: “ ... With more assets on their balance sheets, certain small business lessees, like community banks, might be required to increase their capital reserves ... to satisfy capital adequacy rules.”

Discount rate
Consistently with existing standards for finance leases, the Boards propose that the lessee's incremental borrowing rate be used for deriving the ROU asset valuation from the lease rentals and the interest expense profile.

Dacourt opposes this, suggesting a standard commercial discount rate for all lessees rather than variable rates reflecting the individual lessee's credit standing.

Lease continuation periods

In contrast with existing accounting rules, the ED proposes (for both lessee and lessor accounting) that some lease continuation options should be accounted for as part of lease valuations. Entities would have to estimate the longest period for which an asset was more likely than not to be retained by the lessee, and treat this as the lease period. The expected outcome would have to be reviewed, and the accounting adjusted where necessary, at each reporting date within the lease period.

On the part of lessees, the ED would require similar advance estimation on contingent rentals. Some of those payments are more typical of real estate leasing, but they would also include mileage charges which are typical of vehicle leases.

The bulk of responses to date are opposed to the proposal on continuations. Ernst & Young (E&Y) says: “We believe the proposal requires amounts that do not meet the [normal] definition of a liability to be included within the lessee's liability to make lease payments ... We have significant concerns regarding whether [lessees] would be able to appropriately estimate lease terms, particularly for renewals in the distant future.”

“We believe that the lease term should only include optional lease periods that are reasonably certain to be exercised. We view this threshold as higher than 'more likely than not' and consistent with the threshold used under current accounting ... The current definition of lease term is clear today and works well in practice and we see little benefit in moving to the definition proposed in the ED.

“We understand that the Boards' [proposals are] ... in part due to concerns that other thresholds would allow entities to structure lease contracts to achieve desired accounting results that are inconsistent with the economics of the arrangement. However, we believe that options to extend or terminate a lease generally have

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economic substance and pro-vide flexibility to a lessee ...”

Though this major audit firm is otherwise supportive of lessee capitalization, it makes it clear that this support is conditional on modifications in this area. E&Y says: “Our support for recognizing leases on-balance-sheet is conditional on establishing a more practical approach for measuring the ROU asset and liability than that proposed in the ED.

“In the absence of the Boards making significant changes to the proposed model ... we are not supportive of the proposed accounting for leases. The model proposed in the ED would entail the use of significant estimates and judgements and result in lessees recognizing amounts on their balance sheets for which a great deal of uncertainty exists as to measurement ... “

“We believe that the burden that would be borne by lessees in preparing financial state-ments under the proposed model would, in many cases, outweigh the benefits of provid-ing this information.”

PwC's comments on continuations concur with those of E&Y. It says: “We believe that optional extension periods should be included in the determination of lease term ... only where it is 'virtually certain' that the option will be exercised – that is, structuring of the contractual terms as an option was non-substantive.”

SFRB states: “We do not agree that amounts relating to renewal options and contingent rentals should be recorded as liabilities. Only contractual obligations should be reported.”

“An entity's need for optimisation and supply of property, plant and equipment is based on [its] business plan, normally not exceeding five years, as acknowledged in IAS 36 [the IFRS standard on] impairment ... To consider a lease term exceeding both the business plan [period] and the contractual term would mean recognition of assets and liabilities lacking the evidence that is required in all other transactions ... We question whether users of financial statements will find information useful, which is not supported by a company's usual planning process.”

DASB concurs, commenting: “We question whether the measurement of a liability that will not necessarily result in an outflow of resources meets the definition of a liability in the current and new Frameworks. We believe that the liability should be measured on minimum lease payments including bargain [extension or purchase] options. All other contractual options [should be] disclosed [in notes to the accounts].”

Financial Reporting Advisors (FRA), a US provider of accounting advice on complex business transactions, comments: “One of the essential characteristics of a liability is that the obligor has 'little or no discretion to avoid the future sacrifice' (FASB Concepts Statement no. 6) ....

“We understand the need to consider uncertain amounts in the measure of the liability ... However, we do not believe that need extends to amounts that can be avoided by simple choice ... [with] no significant economic penalty ... {The ED would make] unlike lease arrangements look alike.”

EFAA argues that “[The ED's] conceptual approach [on lease continuations], while reflecting economic reality, is in sharp contrast to other IFRS [such as IAS 37 and IAS 19].”

The Australian ASBs say: “The [ED] proposals will cause the lessee to recognize a liability to make lease payments and the lessor to recognize a right to receive lease payments, notwithstanding that the Framework definitions of assets and liabilities are not met.”

Nayer is another critic within the audit profession: “From an operational standpoint, it is often very difficult to determine if a lease will renew five or 10 years in the future. [The lessee's] business model may change ... “

“The need to re-evaluate these assumptions each reporting period will add work not only for lessees and lessors, but also from an audit standpoint ... I do not see how [the lease continuation proposals] will provide additional useful information to the user.”

Several other respondents agree. US lessor First Financial Equipment Finance says: “... Capitalizing estimated renewal ... rents [would] result in over-capitalisation and an impact to the income statement and statement of cash flows that does not reflect the economic reality of the leases.

“The requirement for both the lessee and the lessor to estimate [continuation] payments will lead to a lack of symmetry between them in the same lease and a lack of comparability among lessors ... and lessees, due to the lack of objective, reliable measures.

“The complexity in the existing rules ... cited [as rationale for change] is the one-time classification of a lease whereas the proposed rules make complexity a perpetual event, perhaps as frequently as monthly, as estimates are made, and then adjusted...”

Among lessees, US mechanical engineering contractor Irex Corporation comments: "... This requirement is too theoretical and certainly too impractical to be useful. [It] ... results in the recognition of a liability that does not legally exist...

"It also requires management to make very subjective judgements about the future when it does not have enough information to [do so] .... Moreover, the auditor would be unable to audit the subjectively determined lease term other than through management's representations. This added subjectivity to the audit process has the potential to increase time and fees with the cost outweighing any possible benefit."

CFS says: "We consider it incorrect to view a lease option ... as a liability. The payment of rent in the option period is not based on a past event as the [normal] definition of a liability requires ...

"The ED proposal ... depresses financial ratios and increases reported interest expense, an outcome that increases in intensity with the length of the available option. This gives the perverse result that the lessee is worse off financially if he has an option than if he does not, when the real world result is that he is never worse off (since he can always decline the option) ..."

Wagner comments: "Only the base period should be accounted for as an asset with a liability. The method suggested by the ED ... involves estimating the probability for each possible term for each lease.

"The cost of implementing and maintaining this method will far outweigh the benefits, particularly for large entities with hundreds (or possibly thousands) of leases. Whole new systems of internal control, data collection processes and software development will be required.

"Estimating a probability will introduce much subjectivity into the process, thereby reducing the comparability and usefulness of the information and ... there would be added cost ... to audit."

Harding makes the same point. "Assuming we do have to apply the ROU model the term should only be for the stated/ fixed portion of the lease term and it should not include 'judgemental/ non-contract' assumptions related to whether a tenant is going to exercise a renewal option. The Boards today are concerned about similar leases being accounted for differently; and that will clearly be the case [on renewals]."

"I am concerned that tenants would have to disclose their renewal intentions, and [about] what that does to the whole landlord/ tenant lease negotiation .... Tenants could manipulate their balance sheets and earnings."

Holcim comments that "Rentals payable during an extension period under an option which has not yet been exercised do not meet the definition of a liability based on the Conceptual Framework [for convergence standards] as the lessee does not have an unconditional obligation to pay it."

Cathay Pacific agrees, commenting: "...As the option/ contingent rental is not a present obligation and does not arise out of a past event, it does not meet the definition of liability under the Conceptual Framework or existing standards."

Tata Steel Europe is another opponent among lessees. It says: " ... Options to cancel and extend leases provide a lessee with flexibility to react to changing business circumstances and their inclusion would result in overstating liabilities and related measures of financial leverage."

Kraut opposes the ED proposal in respect of equipment leasing: "For other than rentals of real estate, taking renewal options into account for lease term is ill conceived...... As long as the footnotes disclose [extension option data], ballooning the balance sheet is inappropriate."

- Impossible to determine

CFS comments: "Making the determination of what is 'more likely than not' will often be an exercise in crystal ball gazing and arbitrary choices. We have retail chain clients with as many as 40 years of [real estate lease] options following an initial 10 or 20 year term. No one can possibly know what the business conditions will be ... 50 years into the future. The attempt to quantify an inherently uncertain situation [would lead to] accusations of financial engineering, as well as requiring resources to be spent in review and estimation that are ultimately unproductive."

As an equipment lessor, Mirsky argues that extension outcomes "are impossible to determine at the beginning of a lease. Any decision to capitalize renewals in advance will be purely arbitrary and not depictive of reality."

Somerset Capital agrees that lessees will find the required continuation estimates very difficult. It says: "Many of [our lessees] have difficulty determining their needs for equipment 30 days prior to the expiration of their leases ... [We] cannot see how those customers will, with any degree of certainty, be able to provide useful estimates of their end of lease term expectations at the inception of a lease."

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Dacourt opposes this proposal for all leases. It comments: “Unless the renewal option rents are at such bargain levels that the [lease] is certain to be renewed, then the [recognized] lease term should be the primary ... term.”

Referring to longer term real estate leases, Dacourt adds: “...Assigning renewal probabilities is a highly uncertain endeavour.... It is highly unlikely in our opinion that longer term predictions could ever achieve even a 50 per cent accuracy rate.”

Security Finance, a US commercial lender commenting as a lessee, makes the same point – and considers it relevant to both property and equipment leases. “A lot of circumstances can change during a 5-10 year real property lease that has an automatic ... renewal option clause. The confidence level of predicting the probability of [subsequent renewal] on a new operation or piece of equipment at inception is extremely low.”

Bosco makes a similar point: “One company I worked with said that virtually all its [continuation option] estimates in its 13,000 real estate leases will be wrong one month after inception ...

“Estimated [non-bargain] renewal options ... are not liabilities of the lessee at lease inception. They should not be capitalized, because they do not meet the definition of a liability since the lessee controls the obligating event - that is the exercise of the option.”

Jackson Cross is equally critical on this point. It comments: “Many major leases may have three or more options to renew. Under the proposed standard, a business may need to determine whether [it] might exercise an option 10, 15 or 20 years from [inception]. Those options may not ever become obligations, and to value them as a future liability and/ or an asset is to misrepresent the true financial position of the company to users of financial statements.”

“The resulting restatement or adjustments for guessing wrong will impact future earnings on a quarterly basis. For companies with hundreds or thousands of leased locations, the constant adjustment would make every quarterly report an exercise in manipulation.”

- Extra complexity

International Decision Systems (IDS), the US based provider of software and solutions for the asset finance market, comments: “The inclusion of renewal payments in the definition of lease term is problematic for both lessees and lessors. It will create significant mismatching of assets and liabilities between lessees and lessors as they try to determine the vague guidance of 'more likely than not'. The requirement to continually review and restate assets and liabilities will create an onerous burden ... and is not feasible for lessors of large portfolios ... and creates the potential for an environment of non-compliance with the new standard.”

Somerset Capital comments in similar vein: “The [proposed requirements for] estimated extension term and rent would produce many structural problems for lessees and lessors. Since these facets would be based strictly on estimated guesswork, it is almost certain that lessors and lessees would estimate different terms for [identical leases].

“Given this, [lease extension] negotiations would become more difficult due to the mismatched estimated lease terms. Lessors and lessees would probably need to keep two sets of books and systems, one for the real lease term and one for the estimated lease term. This makes little sense and is extremely cumbersome and costly to all parties.”

Paul Wilmesmeier, CFO of independent lessor Geneva Capital, stresses the compliance problems for lessors: “[Anticipating] renewals is highly subjective. This opens the door to manipulation by lessors. Different lessors could estimate the lease term of the same lease radically differently.

“... It is [also] extremely labour intensive. Revising estimates on leases in our portfolio ... every month would be impossible for our current staffing levels.”

- Supporters

Among the ED's supporters on continuations, the Florida Institute of Certified Public Accountants (ICPA) merely calls for a clarification: “... Language should be added to state that the lease term should be the longest possible term that is more likely than not to occur ... based on 'historical experience'. ” IDW says: “Despite the fact that the proposed determination of the lease term requires a significant amount of judgement, we support the [ED proposal] ... If optional periods are not included in the lease term, the measurement of the ROU asset and the lease liability might be inappropriate.”

Greg Klein focuses on real estate leasing, commenting: “The current rules ... are misleading and do not report accurately the true nature of many real property lease transactions....”

“Most [lessees] are going to end up paying

significant lease payments relative to fair market value (FMV) of the property over the period of the lease ... At the end of the lease term the lessee could decide not to renew but only at that time would I conclude that the lease is not going to be [continued]."

ACAG suggests a much more limited inclusion of continuations: "Inclusion of options to extend does address potential structuring opportunities, but [we] consider the proposed 'more likely than not' test to be subjective. ... We suggest entities only include options to extend where [continuation] is 'highly probable'."

HoTARAC takes a similar view, and comments: "A lessee would usually be free to choose whether to exercise the [continuation] option and would therefore have no present obligation to the lessor [at inception]. The proposed approach may therefore undermine the [parallel Conceptual Framework proposals].

"It could be difficult, at the date of commencement of a lease, to determine the likelihood that an option will be exercised. It would be especially difficult for the lessor, as the exercising of the option is not within its control.

"The requirement to make such estimates would lead to greater reliance on management judgement which could be selective and open to manipulation to achieve desired accounting outcomes."

Other views

Some respondents favour a more limited inclusion of extension options. The Pennsylvania Institute of Certified Public Accountants (PICPA) says: "[The ED] methodology introduces unnecessary complexity into the standards and results in a contrived lease term that is likely not to occur. Furthermore, adjusting the amounts based on revisions to this lease term creates fabricated income statement adjustments that have no meaning."

"We believe that a lease term should not include a renewal option until it is probable that the option will be exercised ..."

"To minimise the opportunities for transaction structuring, management's intent could be disclosed and the likelihood of renewing the lease could be qualitatively evaluated based on the nature of the lease and the company's history of performing in accordance with [its] stated intentions."

"This provides for a more principles based approach ... There would then be no need for partial weighting of potential outcomes."

The Institute of Chartered Accountants of Scotland (ICAS) reports divided views among its members: "Some members disagree with [the ED proposal] ... as they believe a likely extension of a lease does not meet the definition of an asset or liability under the Conceptual Framework."

"Other members believe it would be appropriate to recognise certain changes in the lease term but believe further work is required in setting a threshold of likelihood at which such changes should be recognised.".

Purchase options

The ED proposes that non-bargain purchase options (NBPOs) – i.e. lessees' options to purchase assets at the end of a lease period, for a more than nominal exercise fee - be accounted for only as and when the options may be exercised.

Due to VAT factors – and, in some countries, the fiscal depreciation rules in business income taxation – NBPOs are not common in European equipment leases. They are, however, common in asset finance in some other jurisdictions. They can also be used everywhere in consumer finance (e.g. personal contract purchase in the car market), though lessee accounting will not be relevant in that case.

Somerset Capital supports the exclusion of up-front accounting for NBPOs, but suggests that the ED proposal on this is inconsistent with what is proposed for lease continuation options. It says: "It appears that [the proposal to account for] the extension of a lease ... is an attempt to quantify the lessee's full likely potential obligation in respect of the leased asset. ...

"It [therefore] seems incongruous that the lessee not be required under the same standard to quantify its purchase of the subject asset at the end of the lease term ... [We] cannot see the theoretical distinction between a purchase and an extension option in a lease for this purpose ... [This] difference in treatment ... is one of the serious weaknesses of the proposed standards."

From a different standpoint, lease broker Rick Hall is critical of the ED proposal on NBPOs. He comments: "My issue relates mostly to equipment financing using a traditional FMV type lease. These lease are used today most specifically to move off balance sheet the true economics of the financing arrangement."

"The most common end of term [outcome] is an eventual buyout of the lease ..To ignore this 'more likely than not' payment in the valuation of the lease obligation is to perpetuate the current failure to

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meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions.

ACAG and BHA are among very few respondents to support the ED's proposal to exclude NBPOs, while also giving at least limited support to the inclusion of lease continuations.

Scoping out

The ED proposes that certain lease transactions should be "scoped out" from the leasing standard, with the parties to the transactions accounting for them as outright sales and purchases of the assets rather than leases. This would apply where "all but a trivial amount of the risks and benefits of ownership" of the asset transfers to the lessee."

That definition is widely understood to mean principally hire purchase type transactions with bargain purchase options, which are among those accounted for as finance leases under existing lease standards.

The substantive accounting for scoped out transactions would remain similar to that for finance leases at present. Nor would it be materially different from that for those finance leases which are not scoped out as a result of residual value (RV) falling short of the "all but trivial" criterion. However, the rules would be found in separate accounting standards in IFRS and US GAAP, and not in the leasing standard.

Several respondents are critical of the scoping out proposal. BHA, though supporting all other main proposals of the ED, comments: "This distinction introduces a complicated bright line test where none is needed ... If the end result [of scoping out] were momentous then it could be worth the difficulty, but the difference between having and not having this distinction will be minimal in accounting terms.

"... The distinction will be thoroughly misleading in legal terms to readers of accounts. There is little difference between showing a purchase of 100% and a right of use of 95% of the cost of an asset on a balance sheet.

"There is however an enormous legal difference between an asset that is owned outright and one whose ownership resides with a third party. In the first case there is a huge legal process to be gone through before an owner can be deprived of his asset. In the second case, the 'would be' owner has to have performed all its material legal obligations before it can finally acquire title."

"...The [accounting] distinction between purchases and lease should be on the basis purely of title. Previous accounting definitions of what should constitute a purchase will cease to have the same relevance when the [new lease] accounting standard ... comes into effect. Far from the authors of this ED having to take note of other standards defining purchases, ... the authors of those other accounting standards should adapt to this one."

Short term leases

The ED makes separate proposals for short term leases (i.e. those with less than 12 months to run at inception and with no continuations beyond that period). This involves what the ED terms a simplified approach, as an optional alternative to reporting in line with the new requirements for other leases.

This approach would work in different ways for lessors and lessees.. Lessors in these contracts could comply with the current rules for operation leases, with only the underlying asset reported on the balance sheet.

Lessees would still have to record ROU balance sheet entries for the outstanding lease payments, though they would not have to apply all the accounting steps as proposed for longer leases, including the application of PV discounts to these amounts and the substitution of amortisation payments for actual rentals in the P&L account.

Short term leases, such as plant hire in the construction sector, are not within the usual concept of mainstream asset finance. However, they are emerging as a focus of wide-spread criticism of the ED requirements for lessees.

DASB says: "We do not believe that the proposal for short term leases is a simplification. [Lessees] would still have to keep track of all short term leases during the year. We recommend to scope out all short term leases [from the new standard], since these leases are not material for the financial statements. Furthermore the benefits [from on-balance-sheet accounting for] short term leases ... are not expected to exceed the costs."

Irex stresses the practical problems for lessees. It comments: "The definition [of short term leases] is so broad that it seemingly would include daily auto rentals ... and any other short term rentals of equipment ...

"At any point in time ... we have at least 100 pieces of equipment (primarily lifts, scaffolding, and trailers) at job sites around the country on short term rental. The rental agreements do not have fixed terms. The rentals typically are subject to monthly, weekly, and daily rates that result in a charge for the actual amount of time that the equipment is used.

"The rental rates inherently include a substantial service component for the delivery and pick up of the equipment, maintenance, refuelling, cleaning, and significant administrative costs. However, it is doubtful that the lessee could easily break out the service component from the lease component in these rental agreements. Moreover, since the rental agreements are open ended, it would be difficult and certainly very impractical to calculate or estimate a lease liability for an indefinite period of time ...

"The ED should be amended to provide an exclusion for short term rentals of equipment with a duration of 12 months or less that include a significant service component."

The Australian JABs suggest a much simpler approach for lessees. They comment:"... For reasons of cost/ benefit a better approach would be ... to allow the lessee to elect to expense the lease payments and not to recognise a ROU asset and a corresponding liability (similar to [the proposal for] lessors ...).

"This concession should only be available on leases for less than 12 months with no option to renew; otherwise structuring opportunities may arise."

Kindred Healthcare is strongly opposed to the short term lease proposals on cost/ benefit grounds. It says: ".. [We] enter into medical and other ancillary equipment leases with unspecified lease terms in each of [our] hospitals and nursing and rehabilitation centres ... These lease terms have ranged ... from one day to one year with the average term [around] 45 days.

"... The new guidance would require that each time a specific leased asset is delivered to [us], a new lease is created requiring the estimation of a new lease term and new lease obligation.

"In addition, most of our service agreements provide a unilateral option for the lessor to substitute the leased asset. Our understanding is that this substitution creates a new lease for accounting purposes ...

"The guidance would require [us] to maintain a short term leased assets inventory system and establish an asset and liability for thousands of these short term lease transactions, the majority of which may require frequent changes in estimates in subsequent reporting periods.

"The administrative burden and associated costs of managing a high volume lease portfolio with terms of short duration would be substantial. [Yet] ... the estimates inherent in the calculation of these lease costs may not be as precise as the current operating lease expense recognition methodology ...

"Including short term leases in the scope of the new guidance creates less transparency in our financial statements and more earnings volatility... It is not consistent that the lessor can elect not to recognize the [short term] lease asset and liability while the lessee is prohibited from making such an election."

"Wet leases"

Some respondents , whether or not they support the general principle of lessee capitalization, call for separate treatment of "wet leases" in shipping and aviation.

Cathay Pacific comments: "This airline sees particular problems with "wet leases" - i.e. service-inclusive leases of up to two years of aircraft with crew, chargeable according to hours of operation. These may be sub-leases of aircraft subject to other ("dry") head leases, and may sometimes exist within a corporate group. Cathay Pacific says: "The proposed standard makes no differentiation between 'wet' and 'dry' leases which at both a company and consolidated level could lead to duplication of asset recognition and unhelpful complexity."

neoCFO, an Indian provider of finance and accounting advisory services, says: "In shipping and airline industries, operating leases are sub-classified into ... wet leases (time charters) and dry leases (bare boat charters). The latter alone can be termed a lease in the true sense. We suggest that the standard should require only a disclosure in the notes to the accounts in all cases involving wet leases."

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Lessor accounting

The hybrid model

The ED proposes a "hybrid" model for lessor accounting. Where lessors retain "significant risks and benefits" on the asset, they would have to account under the performance obligation (PO) model. This would involve recognizing both the underlying asset and the lease receivables on the assets side of the balance sheet – and a liability representing the obligation to make the asset available to the lessee. A netting presentation would prevent inflation of the overall balance sheet number resulting from the duplicated recognition of part of the asset value.

In other cases lessors would use the de-recognition (DR) method. The asset would be divided into the lease receivables and a "residual asset" (RA) corresponding with the conventional concept of RV. There would be no liability specific to the lease.

PwC is highly critical of the ED proposals for lessor accounting, and suggests that the whole lessor side of the exercise should be deferred. It says: "We believe that the PO approach is not consistent conceptually with the proposals for lessee accounting. The DR approach is a better fit with the ROU approach, but applying it to all leases would be inconsistent with [a separate ED on Revenue Recognition].

"We are also aware of a number of practical issues in applying the DR approach for certain types of leases such as [some] real estate leases and time charter shipping.

"We agree with the Boards' acknowledgement that lessee accounting is of greater concern to users than lessor accounting. Although we would prefer the Boards to look at lessor and lessee accounting at the same time, we do not believe that the proposed hybrid approach is a sufficiently significant improvement to current guidance to justify the substantial cost of change. Accordingly we recommend that lessors [be allowed to] continue to apply the existing lease guidance until the Boards are able to develop a lessor approach that is consistent with both lessee accounting and leases/ licences of intangible assets ...

"We believe that the numerous projects the Boards aim to complete over the next year will allow limited time to develop and improve the lessor model ... The Boards' primary focus should be on lessee accounting and ... lessor accounting should be revisited in the future."

PwC acknowledges that deferring lessor accounting could give rise to some problems with sub-leases and sale and leaseback transactions, which raises issues in both lessor and lessee accounting. However, it comments that "We believe these issues can be adequately addressed in the interim."

ICAS expresses reluctant support for the hybrid model; yet in doing so it underlines some of the difficulties seen by audit professionals with the outcome of the Boards' work on the lessor side to date. It says: "Conceptually we are less comfortable with the proposals for lessor accounting than we are with [the lessee side] ...

"We feel that if a single approach is possible for lessee accounting, the same should be true for lessor accounting and we are concerned that the hybrid approach ... will provide opportunities for leasing transactions to be structured so as to achieve a desired accounting outcome.

"However, we have been unable to identify [an appropriate] single approach ... We recognize that a hybrid approach may in fact be necessary in order to reflect the different ways in which a lessor may manage its business."

Among lessors Somerset Capital is strongly critical of the whole ED approach on the lessor accounting side: "It appeared [earlier] that the [Boards] did not see many problems with the current standards with regards to lessor accounting ... The proposed changes in lessor accounting appear to have been developed out of a desire to create symmetry [with the lessee accounting side]in the ED...

"[This] creates significant changes to a set of standards that apparently are not considered inadequate, misleading or otherwise deficient. Change for the sake of change is usually not a worthwhile endeavour and even less so when the costs of implementing such changes are substantial, producing lower margins for the lessor and potentially higher costs [passed on to] lessees."

Wilmesmeier agrees: "I was extremely surprised to discover the quantity and complexity of the proposals for lessor accounting ... What we see in the ED with respect to lessors appears to be a solution in search of a problem. I see no reason to undertake so many significant accounting changes with little or no justification."

HoTARAC, though supporting the hybrid model, argues that the ED criteria " ... do not unambiguously determine when to apply each of the alternative approaches." HoTARAC suggests that the ambiguity would be reduced if the criterion for applying PO (or for not applying DR) should refer to "risks and benefits" rather than "risks or benefits" in relation to asset value.

Views on the models

Several equipment lessors are especially critical of the PO model. Somerset Capital says: “We do not see a theoretical justification for recording a liability to perform on the books of the lessor merely [by] the execution of a lease contract ... The 'performance obligation' is usually met by the lessor doing nothing more than providing ... the customer with the equipment and the lessor typically has limited ongoing obligations to perform under the lease.”

First Financial is also strongly opposed to PO. It argues: “The PO method does not comply with the basic premise that an ROU has been transferred and the lessee is obligated to pay rent ... If there is a lessor performance obligation that remains unfulfilled and its risk of [non-performance] is so high that it precludes the lessor from de-recognizing the value of the asset transferred, then no receivable should be recorded by the lessor. Likewise the lessee should not capitalize the lease. The proposed method seems to be merely deferring revenue recognition without basis.”

FRA is another strong critic of PO. It says: “The performance obligation recognized under this approach is difficult to explain and is inconsistent with the notion of a performance obligation under the proposed Revenue Recognition standard.”

FRA proposes that where lessors assume little RV risk they should account for the transaction under DR, but in other cases they should remain subject to existing rules.

Bosco strongly supports DR: “The lessor PO versus DR lease classification criteria as proposed are not the [true] indicators of when a lessor has a performance obligation ... The DR or a modified DR method is appropriate for all leases. This is based on the basic premise that a lease transfers the value of the right to use an asset from the lessor to the lessee.”

The Australian JABs also support DR for all lessors. They comment: “[We support] a single model for lessors ... The [DR] model is a faithful representation of the leasing transaction and will result in information ... that is more relevant and understandable for users of the financial statements. In contrast, the PO model does not appear to be consistent with the ROU model required of the lessee ...”.

IDW is another audit profession voice in favour of DR. It says: “A single lessor approach is preferable as it would increase the comparability of financial statements, reduce the opportunity to structure transactions and avoid undue complexity ...

“The PO approach is inconsistent with the proposed approach to lessee accounting ... Despite the proposed (linked) presentation of a net lease asset or not lease liability, the PO approach double counts assets. The lessor recognizes separately a receivable ... and continues to recognize the whole of the underlying asset. Thus, the assets recognized by the lessor will exceed the cash inflows expected from those assets.”

UK accountant Gary Pickard agrees that DR is the only approach to the lessor side consistent with the ROU model for lessees: “The PO approach requires that the underlying asset is recognized as an asset twice in balance sheets [of lessor and lessee] ... This would be counter-intuitive to users of financial statements if a ROU approach is to be consistent.”

“On the other hand, the DR approach would mean that the underlying asset is removed from the lessor's balance sheet .. The 'right to receive lease payments' debit in the lessor's balance sheet would correspond with the 'liability to make lease payments' credit in the lessee's balance sheet. These aspects would be consistent and would be simple to understand [for] users of financial statements.”

ACAG also agrees: “The lessor should only apply the DR approach as it best reflects the underlying economics of a lease transaction.”

Barnard is the same camp, commenting: “The problem with the PO approach is that it is conceptually suspect, and introduces asymmetry with [he proposed] accounting for lessees.

“Apart from signing the contract and delivering the asset, what is the ongoing performance obligation of the lessor? ... The DR approach is much closer to the legal and economic impact of a lease transaction from the lessor point of view.

“I do not buy the objection [as stated in the ED] to a single approach to lessor accounting [based on] 'differences in the economics of the business model for different lessors' as this argument could also be employed against a single approach to lessee accounting, and it is spurious ...

“The DR approach ... will provide more meaningful information to [account] users, is a better reflection of the conceptual, legal and economic basis underlying lessor accounting and would aid comparability, transparency and understandability ... ”

IDS comments: “The PO model is inconsistent with equipment leasing transactions. Lease agreements are structured such that the lessee has 'quiet enjoyment' once the equipment has been placed into service. Equipment lessors have no continuing obligation to perform under the lease. The PO model also creates a loss of symmetry with lessee accounting and does not reflect the reality of the cash flows inherent in the lease.”

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Mindthegaap takes the same position. It argues: “The PO approach is inconsistent with the proposed approach to lessee accounting ... The lessee will record a ROU asset representing the right to use an underlying asset over the lease term. It logically follows that the lessor must have given up some of the economic benefits associated with the underlying asset (or exchanged those benefits for [the lease] receivables). This exchange is faithfully reflected in the DR approach....”

“The PO model overstates the sum total of the lessor's and lessee's assets because the carrying value of the lessor's underlying asset overlaps to a large extent with the economic benefits that are represented by the lessee's ROU asset.”

DASB states: “We do not agree with the two models for lessor accounting. The distinction between [the two] appears to be a similar distinction as between operating leases and finance leases which the ED wants to eliminate. We believe that the ... DR model [should] be applied for all leases ... The DR model is consistent with the principle that an asset consists of multiple ROU units [i.e. for the lessor, receivables and RV].”

SFRB also notes the hybrid model's failure to break with the finance/ operating lease distinction and suggests an inconsistency with the lessee side proposals.

Linus Low says that the lessor accounting approach “seems to be conceptually inconsistent with the paradigm shift from a 'risks and rewards' model to a 'control' model that the Boards have recently proposed [in the draft Revenue Recognition standard] .. For conceptual consistency, lessor accounting should be based on the same model as revenue accounting. It perturbs me that the Boards are retaining the 'risks and rewards' approach for lessor accounting while transitioning to the 'control' model for revenue accounting....”

On the proposed DR model, Low comments: “I question the relevance and usefulness of retaining a 'residual asset' in the statement of the financial position when the lessor determines that it no longer retains significant risks or benefits in the underlying asset.”

Ramchurun supports the DR alternative – but also strongly agrees that the lessor side proposals seem inconsistent with the conceptual basis of the project. He says: “Alternative treatments [based on] 'significant exposures to risks and benefits' ... remind us of the old phrase 'significant risks or rewards' used to distinguish finance and operating leases, [so] we are not going towards a consistent framework....”

“In my opinion only the DR approach should be adopted ... How can we create two assets in two financial statements – of the lessor and lessee – with only one physical asset?”

Low concludes: “I strongly urge the Boards to 'put the horse before the cart' and initiate a conceptual debate on the merits of the 'risks and rewards' model vis-a-vis the 'control' model ... This should be done in the context of the joint Conceptual Framework project.

“I am aware that the Boards are under tremendous time pressure to complete the projects under the Memorandum of Understanding (MoU) by June 2011. Notwithstanding this, it would be strategically myopic to sidestep difficult conceptual issues just for the sake of meeting aggressive project time lines.

“Conceptual inconsistency would not only defeat the purpose of current reforms to enhance the financial reporting standards, but would undermine the investors' confidence in financial reporting and the accountancy profession at large. ...I fervently hope that the Boards will not compromise sound principles for short term expediency in their ongoing work to revamp and converge the accounting standards.”

Harding suggests retaining the existing accounting rules for lessors, on much the same grounds as he argues in the case of lessee accounting – i.e. that existing rules are adequate and change would bring unnecessary compliance costs.

PICPA is among the minority of respondents expressing a preference for PO. It suggests that this method is more consistent with the separate draft standard on Revenue Recognition. It says: “We support standardising the accounting for revenue recognition to the extent possible.

“Lessor accounting does not appear to warrant an exception from the proposed Revenue Recognition standard ... The proposed DR approach adds unnecessary complexity to the standard and is too subjective.”

Impact on the captives

In general, captive lessors will prefer to use the DR model. Under the Boards' proposals only this method will allow some sales profit - proportional to the value of lease receivables in relation to total asset value - to be recognized at inception by the manufacturer (or dealer) where products are sold on lease through a captive arm.

Bosco comments: “Much depends on the interpretation and implementation, but I see a risk that there will be many leases offered with lease terms shorter than the economic life of the underlying asset

and with large residuals that will be classified as PO leases ... This means no sales-type profit recognition."

"Sales-type lease accounting allowed for a better pattern of revenue and tax deferrals on profits in the United States. This meant that lower lease rates could be charged by captives and dealers than third-party lessors. Lessees benefited but that will not be the case under the proposed rules as there will be fewer sales-type lease profit opportunities."

"Captives will be motivated to sell PO leases to third party lessors who will charge higher rates."

Support for the ability of captives to recognize initial sales profit is not confined to the leasing industry. IDW comments: "The DR approach results in manufacturers/ dealers recognizing revenue, cost of sales and gains/ losses at the start of the lease ... Such gains correctly reflect the fact that the lessor has 'sold' part of the underlying asset in return for a receivable."

Amortizing the residual

Under the DR approach where lessors recognize a residual asset (RA), the Boards propose freezing the RA valuation throughout the accounting periods while the lease is running.

Several respondents have all criticised this proposal on the grounds that it does not allow for the "time value of money", which is inherent in the initial measurement in the discount to PV of the anticipated RV at the end of the lease term.

DASB says: " ... Interest compensation for the full investment should be reflected in the lessor's accounting for these contracts. This should be done by accretion of the RV from the discounted PV to the expected RV at the end of the agreed lease term."

First Financial says: "The DR method [as currently proposed] does not allow the RA to be accreted to its fair value. [The solution is to] use [the] implicit rate in the lease to PV the expected RV and accrete the RA over the lease term."

IDS comments: "The disallowance of the accretion of the residual assumption to earnings is inconsistent with the definition of the 'rate charged to the lessee' in the ED ... It seems at odds with the use of the implicit rate as defined ... [in the ED] to represent the cash flows of the lease.".

Great American Insurance Group (GAIG), a provider of lease insurance services, sees deferred income recognition through non-accretion of the RV as one of several factors in the ED – on both lessor and lessee accounting sides – that could add up to a material economic detriment for users of leasing. It says: "[In addition to] the front ending of lease costs [through the lessee amortization proposals], ... the lessor models proposed will increase the cost of leasing to lessees as lessors will have to raise prices to offset back ended earnings patterns caused by [the freezing] of the residual [under DR and] reduction in amounts and volume of sales type leases [where captives become subject to PO] ...

"Increased lease costs will further depress lessee share prices or cause [lessees] to react with other strategies to offset the higher costs like cutting costs or raising their prices (both detrimental to economic recovery).".

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