Lease Project Possible Stalemate

Good or bad for the leasing industry?

Article by Bill Bosco, Leasing 101

The latest FASB/IASB Lease Accounting Project meetings on February 28 and 29 had as objectives changing the lessee cost pattern to better reflect the economics (straight line) and to see if that decision would mean changes to lessor accounting methods that had already been decided. The reason for the continued work on the lessee cost pattern is that most comment letters supported a straight line cost pattern for what we call operating leases under current GAAP. The reason they would re look at lessor accounting is the concern of many Board members that they consider the possible need for symmetry.

The Boards could not agree on a lessee accounting method so they never got to the lessor/lessee symmetry issues. The lessee issue under consideration was the front loaded cost pattern of the right of use (ROU) method for lessees whereby the ROU asset is amortized straight line and interest is imputed versus the ROU liability amortizing using "effective interest method" amortization. The comment letters of virtually all preparers (lessees) and many users (lenders, debt analysts and equity analysts) received by the Boards said that there are two types of leases – leases that transfer ownership (AKA capital leases per current GAAP) and leases that merely transfer a temporary right of use (AKA operating leases per current GAAP). The comments said further that the P&L cost pattern should be different with only former capital leases having a front loaded cost pattern while the former operating leases should have a level cost pattern. In other words should there be 2 types of leases and lessee accounting methods with the ROU or former operating leases having a straight line cost pattern. The FASB agrees while the IASB does not. The IASB thinks that all leases should be accounted for the same citing one of the Project's initial objectives – to

eliminate different accounting for similar leases that is an issue under FAS 13 with its bright line PV test.

The staff presented 3 alternative lessee P&L methods at the meetings – the currently proposed ROU method, a new “interest based” amortization (IBA) method and a new "underlying asset” (UA) based method.

- The IBA method would result in straight line P&L if the rents are level. The IBA method would only be applied to the former operating leases while the former capital leases would either be considered loans and scoped out or use the ROU method as they do under current GAAP.
- The UA method would result in a P&L pattern driven by the depreciation of the leased asset had the lessee owned it using the expected residual as the salvage value. The UA method would only produce a straight line pattern if the asset’s residual is 100% of its fair value at inception (only possible in a real estate lease). The UA pattern would be applied to all leases.

Both new methods were cited as being complex and possibly not operational (unworkable) by lessees. When the Boards voted they were split with the FASB voting for the IBA method and the IASB voting for the UA method. A question was asked whether any board members would support the other method if their method proved to be unworkable. The result was no one would switch their vote. This is a problem threatening the whole project. The next steps they decided on were to have the staff do more work on the new methods and get feedback from users and preparers. They plan on having one more meeting after the results of outreach are reviewed to see if they can come up with a compromise that deals with the lessee P&L pattern issue.

They did discuss possible outcomes and I think three of the four possible outcomes are good for the US leasing industry. One approach is to keep current GAAP with better disclosures and adopting IAS 17 classification tests that are more substance based than

FAS 13's classification tests. A second approach is for the two Boards to part ways and issue separate rules (the FASB would then adopt a straight line lessee P&L cost method). The last approach has two possible outcomes. That is they come up with a compromise and that could be good for the US if the compromise is the IBA method. It would be bad news if they chose the ROU or UA methods which font load costs for equipment leases

Since three of the four possible outcomes are god news for the industry we should all be optimistic. It appears that the FASB has been open minded throughout the project as it has migrated from one that would have significantly reshaped our industry due to its illogical and burdensome lessee accounting methods to one where the results will more closely match the lease economic effects.

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