Origins, Outcomes, and Justifications for the FASB/IASB Exposure Draft on Leases

ACCT 5335 Graduate Paper

Nicolas A. Valles

"The leasing industry plays an important role in many economies by helping companies manage cash flow and working capital," IASB Chairman Sir David Tweedie said in a press release. "However, much of the estimated annual $640 billion of lease commitments fails to appear on the balance sheet of lessees, thereby giving a false impression of companies' liabilities and gearing" (as cited in the Journal of Accountancy, 2010).

Leases are important transaction that transcend many industries and affect the financial reporting of the parties involved. On August 17, 2010, the Financial Accounting Standards Board (FASB) released an exposure draft, along with the International Accounting Standards Board (IASB), proposing amendments to the FASB Accounting Standards Codification (ASC) and the International Financial Reporting Standards (IFRS) to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position (FASB, 2010). This paper will discuss the origins, outcomes, and justification for the new IFRS exposure draft on leasing and its likely impact on financial statement preparation and reporting. First, this paper will address the current recognition of a lease by the lessee and lessor under U.S. GAAP as well as the current recognition of a lease by the lessee and lessor under IFRS. Then it will address the proposals of the joint exposure draft and why these proposal will benefit the financial statement users and prepares.

Under US GAAP, a lease can be classified as a capital lease or as an operating lease. Four requirements – transfer of ownership, bargain purchase option, lease term, and minimum lease payment – must be met in order to classify a transaction as a lease (FASB ASC 840-10-25-1). The transfer of ownership criteria is when ownership of the property is transfers to the lessee by the end of the lease term. A lease with a bargain purchase option allows the lessee to purchase the leased property at a price lower than the fair value of the property. The lease term of the property must be greater than or equal to 75 percent of the estimated economic life of the leased property. The minimum lease payment rule is satisfied when the present value of the minimum lease payments are at lease 90 percent of the fair value of the leased property. If the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, then the lease term criteria and the minimum lease payment criteria will not be used to classify the lease as a capital or operating lease (FASB ASC 840-10-25-1).

If a lease does not meet any if the four requirements, it is classified as an operating lease. In the case of an operating lease, the lessee will charge rent expense for the payments made to the lessor and the lessor will continue to control the asset. As such, the leased property and its depreciation are reported on the lessor's books. The lessor also recognized rental income for the leased asset.

Lessees may classify a lease as a capital lease if it satisfies any of the four requirements previously mentioned. Lessors, on the other hand, must satisfy two additional requirements - the collectability of minimum lease payments is reasonably predictable and that there are no important uncertainties about the amount of unreimbursable cost yet to be incurred by the lessor (FASB ASC 840-10-25-42). There are also three different types of capital leases that can be identified by the lessor, sales-type, direct financing, and leveraged leases. If the lease meets any of the four original criteria and both the collectability and important uncertainties criteria, it is classified as a sales-type lease. It is a sales-type lease because the fair value of the property is greater than the cost of the asset and the lessor recognizes the manufacturer's/dealer's profit. When the lease meets the same criteria, but does not recognize the manufacturer's/dealer's profit it is classified as a direct financing lease. A lease that meets all of the about criteria, involves at least three parties, the financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor, and the lessor's net investment declines during the early periods of when the investment is completed and rises before its elimination, is categorized as a leveraged lease.

International Financial Reporting Standards also classify leases in two categories: financing leases and operating leases. The classification depends on the transaction of the lease rather than the form. Under IAS 17, "a lease is classified as a finance lease if it transfers substantially all the risk and rewards incident to ownership" (Deloitte, 2010). Although IAS 17 is similar to FASB ASC 840, it provides less specific guidance than U.S. GAAP as seen in the five situations that would normally lead to a lease being classified as a finance lease (IAS 17.11):

1. The lease transfers ownership of the asset to the lessee by the end of the lease term.
2. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised.
3. The lease term is for the major part of the economic life of the asset, even if title is not transferred.
4. At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
5. The lease assets are of a specialized nature such that only the lessee can use them without major modifications being made.

As a finance lease, the lessor would treat the lease as a finance sale by replacing the asset with the net investment in the lease, which is equal to the present value of future minimum lease payments. Any profit on the sales is recognized at the inception of the lease, and interest is recognized over the life of the lease using the effective interest method. Under U.S. GAAP, the net investment in the lease is determined simply as the lessor's cost or carrying amount for the leased asset (Doupnik & Perera, 2009, p. 136). Operating leases are treated the same under both standards.

The new exposure draft published by the IASB and FASB proposes that a right-of-use model be used to account for all leases. The lessee would have the right to use the asset for the leased term while the lessor would either take a performance obligation approach or a derecognition approach, depending on its risk or benefits associated with the underlying asset (Financial Accounting Standards Board, 2010). The lessor takes a performance obligation approach when a lease liability is recognized while continuing to recognize the underlying asset. The derecognition approach is taken by the lessor by derecognizing the rights in the underlying asset that is transfers to the lessee and continuing to recognize a residual asset representing its rights to the underlying asset at the end of the lease term(Financial Accounting Standards Board, 2010). The FASB (2010) explains that lessees and lessors would measure the assets and liabilities on the basis that:

(a) assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
(b) uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.

(c) is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

In reference to lease terms, the determination of a lease term as the longest possible term that is *more likely than not* (emphasis mine) to occur is the most systematic way of determining the term of the lease because it utilized a weighted probability. Although there is no conceptually correct probability threshold that should be applied, it would still offer a lease term that is more likely than not that the lessee's right to use the leased item in the optional period will be exercised (International Accounting Standards Board, 2008).

The changes described in the exposure draft would greatly affect companies and organizations that mainly use operating leases to keep the debt off of their balance sheet (Miller & Bahnson, 2010). Since operating leases only affect the income statement, the purposed right-of-use model would force these lessees to recognize the liability and obligation to make the lease payments for the right to use the leased asset on the balance sheet. The lessee would then recognize an amortization expense on the right-of-use asset and an interest expense on the liability to make the lease payments on the income statement. Some might argue that the costs of this model outweigh the benefits because of the time spent performing the calculations, but the right of use model would allow for most leases to be treated consistently, thus increasing comparability of financial statements among companies. In my opinion, the comparability of the financial statements is a greater benefit for all financial statement users and prepares than less work.

This draft proposes that lessors should apply the performance obligation approach or derecognition approach. The performance obligation approach is used by the lessor by permitting the lessee to use the underlying asset during the leased term (KPMG, 2010). This type of lease creates a new asset, the right to receive lease payments, and a new liability, the obligation to permit the lessee to use the underlying asset during the leased term which allows the underlying asset to remain on the lessor's balance sheet. The derecognition approach transfers a portion of the underlying asset to the lessee by derecognizing that portion of the asset and recognizing only the income arising from the portion of the underlying asset that is transferred to the lessee (Financial Accounting Standards Board, 2010). The lessor would have to evaluate their business model to determine what approach to take. The International Accounting Standards Board (2010) explains the following:

> The derecognition approach is likely to be appropriate when the entity's business model is primarily the provision of finance, because the profit of that business is derived from interest income and the principal risk associated with the business is credit risk. The performance obligation approach is likely to be appropriate when the entity's business model is primarily to generate a return from the active management of the underlying assets either from leasing these assets to multiple lessees during their life or from use or sale of the asset at the end of the lease. The lessor may also generate a variable return during the term of the lease by accepting payments that are contingent on the usage or performance of the underlying asset. In that business model the principal risk is asset risk (p. 39).

The exposure draft by the FASB and IASB "proposed to define a lease as a contract in which the right to use a specified asset or assets is conveyed for a period of time, in exchange for consideration" (2010, p. 11). Although it is a very simple definition, it defines a lease well because the lessee has the right to use the asset for the specified time as well as the obligation to pay the lessor for the use of the underlying asset.

When dealing with the presentation of the lease on the balance sheet, a lessee would separate liabilities to make lease payments from other financial liabilities. Lease liabilities should be presented separately since the liabilities related to the lease differ greatly from other financial liabilities(International Accounting Standards Board, 2010). This type of liability payment is related to the right-of-use asset, which can have options to extend the lease term. The lessee would also present the right-of-use asset as if it were a tangible asset in the property, plant, and equipment rather than an intangible asset(International Accounting Standards Board, 2010). This would be a proper way to present the right of use asset since the lessee would generally use the underlying leased assets as property, plant, and equipment.

Under the performance obligation approach, the lessor would present the leased underlying asset, the right to receive lease payments, and the lease liability on the statement of financial position to show how they are related to the lease. The underlying asset and the lease liability would be shown as a net lease asset or a net lease liability. Under the derecognition approach, the lessor would present the right to receive lease payments separate from other financial assets, such as stock and bonds. This is because the cash flows from this type of assets would not be used the same way as those from those financial assets.

For the presentation on the statement of income, a lessee would present the amortization of the right-of-use asset and interest expense on the liability to make lease payments separately from other amortization and interests expense, either in profit or loss or in the notes (International Accounting Standards Board, 2010). These expenses are currently disclosed in the notes of the financial statements, but should be presented in the income statement so financial statement users can truly understand the company's financial performance. The exposure draft explains that lessors should present interest income, lease income, and depreciation expense separately on the income statement when using the performance obligation approach. Under the derecognition approach, the lessor is to present the lease income and expenses according to their business model in separate line items. Some examples stated in the exposure draft (2010) are:

> "If a lessor's business model uses leases as an alternative means of realizing value from the goods it would otherwise sell, the lessor shall present lease income and lease expense in separate line items. Many manufacturers and dealers regard the lease of an asset as equivalent to selling the asset. Those lessors would present revenue and cost of sales so that income and expenses from sold and leased items are presented consistently. If a lessor's business model uses leases for the purposes of providing finance, the lessor would present lease income and lease expense net in a single line item."

Lessees should present all cash payments for leases are to as financing activities in the statement of cash flows and should be present them separately from other financing cash flows (International Accounting Standards Board, 2010). This is a reasonable ruling since the company is financing the asset through the lease liability. If the lessor is using either the performance obligation approach or the derecognition approach, the income received from the lease will be classified as cash flows from operating activities as the lease would be a part the lessors operations. The cash flows from lease income would then be listed separately from other operating cash flows.

Lessees and lessors should disclose quantitative and qualitative financial information that identifies and explains the amounts recognized in the financial statements arising from leases and describes how they may effect the amount, timing, and uncertainty of their future cash flows" (International Accounting Standards Board, 2010). In general, the disclosures required by the exposure draft, are consistent with the disclosures prescribed under IAS 17.31 through IAS 17.56 (Deloitte, 2010) and FASB ASC 840. These disclosures will help financial statement users understand the financial performance of the leases.

When the effective date for this proposal is determined, lessees and lessors will have to use a simplified retrospective approach to apply to all existing leases, not just new leases going forward (Whitehouse, 2009). Lessees will have to recognize a liability to make lease payments at present value and a right-of-use asset for each of their outstanding leases. Lessors using the performance obligation approach will have to recognize the right to receive lease payments at present value and a lease liability for each outstanding lease. Lessors using the derecognition approach will have to recognize a residual asset at fair value on the date of initial application (International Accounting Standards Board, 2010).

Leases are an important part of doing business, whether it is national or international. The current standards distinguish leases as operating leases and capital/financing leases, which affect the financial statement in different ways. The proposals under the FASB and IASB joint exposure draft will standardize how leases will be handled so financial statement users can avoid the uncertainties, such as off balance sheet financing, they are facing with the current standards. Entities that handle a majority of operating leases will be affected the most by these proposal since they will have to recognized the right-of-use asset on their statement of financial position. Overall, the proposals made in the exposure draft will provide better information about the financial state and performance of a business for the financial statement users.

Works Cited

Deloitte. (2010 27-August). *IAS Plus: IAS 17, Leases*. Retrieved 2010 18-October from IAS Plus: http://www.iasplus.com/standard/ias17.htm

Doupnik, T., & Perera, H. (2009). *International Accounting* (2nd ed.). New York: McGraw-Hill Higher Education/Course Smart.

Financial Accounting Standards Board. (2010 16-October). *840 Leases*. Retrieved 2010 16-October from FASB Accounting Standards Codification: http://asc.fasb.org/home

Financial Accounting Standards Board. (2010, August 17). *FASB Exposure Documents Open for Comment.* Retrieved October 16, 2010, from Financial Accounting Standards Board: http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157191432

International Accounting Standards Board. (2010 18-August). *Changes to Lease Accounting – joint IASB/FASB exposure draft released.* Retrieved 2010 20-October from TheIFRS.com: http://www.ifrs.org/NR/rdonlyres/C03C9E95-822E-4716-81ED-04B9CC4943BE/0/EDLeasesStandardAug08.pdf

International Accounting Standards Board. (2008 24-July). *Current Projects.* Retrieved 2010 20-October from IFRS.org: http://www.iasb.org/NR/rdonlyres/D65CA009-D5AE-42BF-8752-867F7338D77C/0/Leases0807b13Bobs.pdf

Journal of Accountancy. (2010 17-August). *Proposal Would Require Most Leases to Appear on the Balance Sheet*. Retrieved 2010 21-October from Journal of Accountancy: http://www.journalofaccountancy.com/Web/20103224.htm

KPMG. (2010 1-February). *KPMG - IFRS Leases Newsletter - Issue 1, February 2010.* Retrieved 2010 18-October from KPMG.com: http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/ifrs-insurance-newsletters/Documents/IFRS-Leases-Issue-1.pdf

Miller, P., & Bahnson, P. (2010). Off-balance-sheet financing: Holy Grail or holey Pail? *Accounting Today , 24* (13), 16-17.

Whitehouse, T. (2009). Hints That Lease Accounting Reform Will Hurt. *Compliance Week , 6* (68), 30-31.